Bring Politics Back to Monetary Policy

How Technocratic Exceptionalism Fuels Populism

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The current battle over the liberal world order seems to be about trade, climate, and security policy. But monetary policy has also become an increasingly important arena of conflict. Populist leaders seem to love nothing more than denouncing central bankers and challenging the legitimacy of the current monetary order, as Trump famously did during the election campaign when he accused central bankers of "doing political things" by keeping interest rates low.

In responding to this challenge, it is tempting to point to central banks' independence from politics as a defense against the dangers posed by erratic leaders. Yet that would be a risky move. It turns out that decades of appeals to technocratic exceptionalism—the idea that monetary policy should be shielded from democratic oversight—has costs. Indeed, it can lead to the very politicization of monetary policy that it seeks to avoid.

Central banks play a paradoxical role in today's liberal democracies. Their work is highly technical, yet the consequences of their actions are inevitably political, producing big winners and losers. They wield great power in democratic societies, and yet they are unelected—because of the fear that politicians tend to push up inflation to appease their bases unless interest rate policy is insulated from democratic pressures.

The underlying tensions in central banks' technocratic exceptionalism became particularly evident in the aftermath of the 2008 global financial crisis. In recent years, their entire mission has become unclear: for decades, central banks have been focused on fighting inflation, yet since the crisis there has been no inflation to worry about despite massive central bank interventions. In fact, the opposite fear of deflation has driven extraordinarily loose policies and a great deal of experimentation—ranging from massive bailouts to quantitative easing and ultra-low (even negative) interest rates. Although more normal conditions appear to be on the way at last, that decade of exceptional policies has taken its toll on the legitimacy of the current global monetary order.

The loudest critics of central banks have been on the populist right—including Victor Orban's regime in Hungary, pro-Brexit forces in the United Kingdom, Marine Le Pen's Front National in France, Tea Party Republicans, and even President Donald Trump in the United States. Riding the growing wave of public skepticism about experts and elites, these illiberal populists have identified central bankers as among the worst offenders.

To save the current monetary architecture against such challenges—an absolutely vital task in a world in which the reliable circulation of money serves as the foundation for economic and political stability—monetary policy needs to have a more robust form of democratic accountability built in. Only then can nations ensure that central banks genuinely meet the needs of those for whom they work: the people.

Of course, with the forces of populist illiberalism on the rise, it is hard not to be relieved that at least some aspects of economic policy are insulated from political oversight. If central bank independence is supposed to protect monetary policy from excessive political pressure, one could argue, then what better example of its merits than the fact that at least a little of the economy is off limits to the Orbans and Trumps of the world.

Yet there is a peculiar irony at work here: this argument suggests that our best response to illiberal tendencies is an equally illiberal strategy of excluding monetary policies from democratic accountability. Although technocratic exceptionalism is tempting, especially in the face of the threat of illiberal democracy, it is also quite dangerous: it reduces accountability even as it never quite succeeds in getting the politics out of monetary policy. This disconnect with the public ultimately fuels the kind of populist backlash the world has recently seen, further politicizing monetary policy with potentially very worrying consequences.

LIBERAL EXCEPTIONALISM

The word "exceptionalist" is typically used to describe an American sense of uniqueness and exemption from the usual global rules. But I draw instead on an analysis of liberal exceptionalism that has focused on security policy: situations where political leaders invoke a state of exception to justify the suspension of liberal democratic rights in order to respond to a severe threat to the nation. This might seem an unlikely place to begin a reflection on contemporary economic policy, but there are rather obvious and important parallels.

This kind of exceptionalism dates back to the Roman practice of dictatorship, which allowed a republic to temporarily cede power to a military leader for a six-month period in order to fight a war. Modern liberal democracies have adopted their own strategies for responding rapidly to a variety of crises, including by building various exceptionalist provisions (such as states of emergency) into their legal systems. These enable the democracies to bypass slower deliberative processes in crisis situations.

Although such temporary states of exception have long existed in democratic societies, they have also, appropriately, been the subject of great debate since they run the risk of eroding the very rights that they seek to protect. Not surprisingly, following 9/11 when many Western states suspended various liberal democratic rights in the name of a security emergency, there was a resurgence of interest in such debates. In that case, and in the case of most exceptionalist security strategies, there is a general pattern, in which an initial declaration of an existential threat to the state (such as the attacks on the Twin Towers) justifies the temporary suspension of normal liberal democratic processes and rights (such as privacy rights), which is then institutionalized through a range of legal, extra-legal, and bureaucratic procedures (such as the use widespread civilian surveillance).

Although a great deal of ink has been spilled on security exceptionalism, there has been very little attention to its place in economic policy. That is surprising, because the history of exceptionalist policy in the West is chock full of cases in which emergency provisions were used to pursue economic ends. Witness the regular reliance on martial law in the nineteenth and early twentieth century to put down strikes deemed a threat to the nation in the United States and and the United Kingdom. Or the use by U.S. President Franklin D. Roosevelt of the 1917 “Trading with the Enemy Act” (1917) to stop a run on the banks by banning the private ownership of gold.

In both of these cases we can see the familiar logic of exceptionalism: a declaration of a serious threat to the nation, the temporary suspension of normal liberal democratic rights, and the implementation of a range of policies designed to put that exception into place.

ECONOMIC EXCEPTIONALISM IN TIMES OF CRISIS

Beyond the familiar tension between the liberal commitment to rights and the demands of security, exceptionalist politics attempt to resolve another tension at the heart of liberal democracy: that between the goals of a stable democratic polity and those of a free market economy. Although a free market economy often supports political stability, the recent global financial crisis reminds that it is also prone to regular, devastating crises.

In such moments of crisis, political leaders have often declared a state of economic exception and have suspended normal liberal democratic norms and rights. For example, during the recent financial crisis, we saw a wide range of emergency economic measures pushed rapidly through legislative processes or introduced in quasi-legal fashion in order to halt the hemorrhaging of the global credit system. As in the case of security exceptions, political leaders generally argued that speed was of the essence, and that the normal processes of democratic deliberation must therefore be bypassed.

Their decisions were nothing new. Writing after the Great Depression and the Second World War, the Austro-Hungarian economists Karl Polanyi and Friedrich Hayek both identified the double-tension in liberalism, ultimately proposing radically different solutions. Polanyi argued in The Great Transformation that one of the major causes of the dislocations of the 1930s and 1940s was that an unchecked economy had ultimately produced both great crises and profoundly reactionary responses. His answer to this core tension was to constrain the excesses of the market for the sake of democratic stability. In The Road to Serfdom, Hayek put forward a very different diagnosis, arguing that it was insufficient market freedom that opened the door to the rise of fascism. He therefore argued for the opposite response, calling for market freedom to be protected at all costs.

If Polanyi’s solution held sway throughout the Keynesian post-war years, Hayek has won the day since the rise of neoliberalism in the 1980s. Hayek’s strategy and the profound skepticism about democracy that it embodies underpin the vast majority of today’s dominant economic theories, as well as many of the economic practices that they justify. For example, public choice theories of rent-seeking and bureaucratic expansion urge mistrust of elected politicians and public servants and the avoidance of relying on the government to provide necessary services. Meanwhile, both the theory of political business cycles and the time-inconsistency hypothesis predict that politicians will tend to promise low inflation early in their terms but ultimately pursue expansionary policies just before elections, creating dangerous inflationary pressures.

By telling us to be wary of too much democracy, and demarcating a range of different economic problems that must be protected from its influence, these policy practices effectively create and reproduce little pockets of exceptionalism on an everyday basis. Economic exceptionalism thus takes two rather different forms in contemporary liberal democratic states. When major crises hit, we often find governments using emergency exceptionalism to give them the power to pull out all the stops in response. At the same time, the underlying fear of too much political intervention has also produced a second, technocratic, form of exceptionalism, which carves off certain areas of policy as too important to be subject to democratic whim. Paying attention to the role of these different kinds of economic exceptionalism tells us a great deal about how central banks worked up until the 2008 global financial crisis, and how they have struggled to make things work since then.

THE RISE (AND FALL) OF THE TWO PERCENT DOCTRINE

Central bankers today see their job as fighting inflation, and they derive their legitimacy from effectively doing so. But with inflation rates at historic lows, and with the global economy in a very different place than it was several decades ago, the decision to continue to make inflation the principal (and in some cases the sole) focus of monetary policy should be seen as a political choice. It is important to ask whether the end of fighting inflation, however noble that pursuit might be, justifies essentially undemocratic means.

The doctrine of central bank independence and the narrow focus on very low inflation are quite recent innovations, dating back to the same Hayekian revolution in political economic policy in the 1980s. Before then, policymakers took a more Polanyian approach to economic policy, tailoring monetary policy to meet a range of political goals. With the pain of the Great Depression still in recent memory, policymakers put more emphasis on full employment than inflation-management, using a range of fiscal, monetary and price-control techniques to obtain the right “trade-off” between unemployment and inflation. This politically hands-on approach to economic management ran into trouble in the 1970s, as successive oil shocks and rising inflationary expectations produced “stagflation”—an intractable mix of high inflation and high unemployment (a nasty conundrum that the United Kingdom may be facing once again).

The economic crises of the 1970s gave the Hayekians and their political supporters on the New Right their chance. They blamed the rampant inflation on overly strong unions (who were demanding higher wage settlements) and too much politics. A new breed of economists argued that policymakers will be prone to time-inconsistency; they would promise low inflation but would deliver electorally popular policies that produce too much inflation. The solution, they argued, was to get the politics out of the picture by not only making central banks autonomous, but also constraining central bankers' discretion through simple rules.

Although there have been a number of variations in this approach over the years, the basic assumptions have remained consistent: if you can limit monetary policy to a set of simple rules and make inflation-fighting the priority, you should be able to create a low-inflation economy. But to make this work, you have to insulate rate-setters from political influence, or all your inflation-fighting credibility will go up in smoke.

Advocates of this system argue that the demands of democratic accountability are met because governments usually choose the objectives that guide central bank policy, even if they must let central banks then decide how to reach them. Yet, the combination of policy autonomy and a very narrow inflation-focused rule dramatically reduces the ability of monetary policymakers to respond to the broad economic needs of the public or the complex demands of a modern economy. Of course, in practice, central bankers have sometimes pursued a more nuanced discretionary policy (as they are arguably doing today). And, of course, they have not always been immune to political pressure. As William Niskanen wrote in his book, *Reaganomics*, "The Fed is independent in the same way that Finland is independent – by accommodating to the strongest external pressures."

Above all, bankers have had to be less than transparent about these facts, further eroding their claim to democratic accountability.

THE POLITICS OF INFLATION

It is clear that the doctrine of central bank independence defines monetary policy as an issue that should be beyond the vicissitudes of democratic pressure. Yet, is this a political move, or merely a technical matter of convenience? To see the politics of it, look to the reactions to recent monetary policy by different groups: homeowners and other debtors have been delighted by recent extremely low rates, whereas retirees have been very hard hit by low returns in safe investments.

Monetary policy has a huge impact on the economy as a whole and also produces winners and losers. For example, increasing or lowering interest rates is as distributional as tax policy. It is just more politically opaque when you reward savers and punish borrowers by raising rates. Similarly, policies of quantitative easing are premised upon a wealth effect where the asset values of those with the most assets are artificially inflated, rewarding those who already have the most. Given that monetary policy is so politically and distributionally significant, policymakers should provide us with very good reasons for radically limiting democratic oversight. On the surface, those reasons are largely technical, couched in the economic language of time inconsistency and moral hazard. Yet, underlying this technocratic rationale is a more fundamental fear about the potentially devastating risks of severe inflation.

As the McGill political economist Juliet Johnson argues in her research on central bank museums, when central bankers set out to explain their mission to the general public, they dramatize the danger of inflation. Every bank museum has a display that discusses the risks of inflation, and many try to make those risks real to the visitor—by for example demonstrating how rapidly their money declines in value over time with a higher rate of inflation. Underlying these discussions of the problems of moderate inflation, however, is the specter of hyperinflation: just about every central bank museum also has a depiction of the horrors of the German hyperinflation of the 1930s, in which families famously had to push wheelbarrows of cash to buy a loaf of bread, producing the political and economic instability that enabled Hitler's rise to power.

The irony of course is that the hyperinflation actually happened in the 1920s and was a deliberate German policy to disrupt reparations to France. It worked in that regard and then was ended by 1924. The suspension of reparations resulted in an economic boom that lasted until 1929, when the world economy fell off a cliff. Hitler came to power in 1933 because of unemployment, but you would never know that from the story central banks tell themselves about 1923. But the story serves a purpose. No matter how remote such a possibility is, it is the fear of hyperinflation that justifies the creation of a technocratic zone of liberal exceptionalism that constrains democratic oversight.

EMERGENCY EXCEPTIONALISM

The technocratic approach to monetary policy seemed to work reasonably well during Great Moderation—a period of unusual macro-economic stability that lasted from the mid-1980s until the 2008 financial crisis. But the 2008 global financial crisis changed everything. In their efforts to fight a global financial meltdown and to stave off deflation, central bankers threw out the rule book and started experimenting with a whole range of unconventional monetary policies.

This is where the second side of exceptionalism has begun to make an appearance. All of these measures have been framed as temporary, exceptional responses to the serious threat posed by the crisis, and thus operate through the logic of emergency exceptionalism. Here again, we can see the classic elements of exceptionalist politics: the declaration of an existential threat, followed by the suspension of normal politics.

Although there were countless invocations of an extreme threat, the most potent was no doubt Federal Reserve Chairman Ben Bernanke's infamous statement to lawmakers that without the rapid roll-out of emergency measures "There won't be any economy Monday." In turn, political and economic leaders who relied on technocratic exceptionalism to keep the politics out began to act in a most political manner — bailing out corporations instead of letting them fail, suspending trading on the stock exchanges, nationalizing failing banks, and pushing through enabling legislation where adequate emergency authority did not yet exist.

Central bankers also moved quickly to adopt various exceptional and unconventional policies in response to the crisis. Indeed, most of the unconventional monetary policies that have been tried to date break quite radically with the underlying economic ideas that justify technocratic exclusion in the first place. For example, when exceptionally low interest rates were not providing enough stimulus in recent years, negative interest rates, which weren't even supposed to be economically possible (until they were tried), were applied. Quantitative easing pushes the envelope on what central banks are supposed to never do: print money.

RESPONDING TO ILLIBERALISM

The rule-based approach to monetary policy was supposed to avoid this kind of ad-hoc policymaking, which is why it isn't too surprising that the current monetary order is facing some serious challenges to its legitimacy. Over the past year, the U.S. Federal Reserve's Janet Yellen, the Bank of England's Mark Carney and the European Central Bank's Mario Draghi have all been criticized for being too political, too powerful, and too unaccountable. Criticizing Carney, for example, became "the new Tory sport" after he warned of the potential economic fallout of a "yes" vote during the Brexit referendum.

Yet central bankers do bear some responsibility for their current woes. Even during the Great Moderation, the underlying exceptionalism of monetary policy had corrosive effects the institutions' longer-term legitimacy. Monetary policy is always political. It is not just that different interest rate decisions have winners and losers, but that the very focus on low inflation (rather than full employment, growth or some other economic priority) has political effects, tilting economic policy towards the financial sector and savers in general, and away from working (and borrowing) families.

The narrow focus on inflation also weakened central banks' ability to foresee the financial crisis. As late at the summer of 2007, the Federal Reserve's preoccupation with inflation levels blinded them to the financial instabilities already at work. And of course, once the financial crisis was in full swing and central bankers began using their emergency powers to respond, the public began to ask how it was that some of the most powerful people in the world were unelected.

These failings are of course only one part of the bigger picture of economic inequality, crisis, and stagnation that has helped to create the conditions for the rise of illiberal populism—but they do play their part. Moreover, by effectively denying the political implications of their actions, central bankers only became further disconnected from the wider public. And yet central bankers are not entirely to blame for their present predicament either. After all, who tasked them with saving the global economy—not just in the early days of the crisis, but for many long years afterwards? Western politicians passed the buck as quickly as they could—shifting from stimulus to austerity in a few short years, and placing the burden for recovery on central banks.

Central bankers and politicians share a common desire: to get the politics out of the process. Unfortunately, it turns out that this is an impossibility. In fact, recent events make it clear that not only are monetary policies inherently political, but the very attempt to separate them from political pressures can produce the opposite effect. This is the paradox of monetary credibility: although economic theory says that monetary credibility and low inflation depend on getting the politics out, at the end of the day, in a democratic society, credibility also depends on the legitimacy of the monetary system and its institutions to deliver policy that works.

Policymakers' efforts to depoliticize economic policy only works to repress and displace those politics, forcing public concerns out of the formal political system and into far more radical and potentially illiberal areas, ultimately threatening the liberal system that policymakers seek to preserve. This is not to suggest that the denigration of expertise it is a justifiable political move. It is instead to urge that observers cultivate a more modest and engaged form of expertise, particularly in areas in which both facts and values are contested—and that definitely includes economics, as the economists Dani Rodrik and Jonathan Kirshner have both eloquently argued.

There are plenty of signs that the old economic certainties of the Great Moderation are gone for good. Yellen and Canadian Central Bank Governor Stephen Poloz have suggested that simple rules no longer apply in a radically uncertain context. And although Western central bankers continue to declare their allegiance to the golden two percent rule, their actions point in a very different direction (recent interest rate increases in the United States and Canada in spite of declining inflation being a case in point).

In the short term, we may well be relieved to know that the norms of central bank independence and rule-based policy provide a measure of protection from populist tendencies under the Trump administration and elsewhere. But when Trump ideologue Steve Bannon criticizes capitalism for its amorality and invokes the concerns of middle-class and working-class people, all the while defining the alt right as their champion, we need to come up with a better answer than "have faith in the two percent inflation target."