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In Defense of Central Bank Independence against its Enthusiasts*

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Abstract

The problem of time inconsistency provides the basic economic rationale behind the independence of central banks, understood as the most suitable institutional mechanism for ensuring price stability. According to the consensus that emerged in the 1990s and the 2000s, endowing the central bank with independent decision-making authority over the use of monetary policy instruments, with a mandate for price stability, enhances the effectiveness of monetary policy and reduces the inflation volatility. It may be surprising that criticisms of the once almost sacrosanct independence arise after the Great Financial Crisis, when it is widely recognized that central banks "saved the world" from repeating the Great Depression of the 1930s. The paper is an attempt to explain the rationale why these cracks in the consensus have arisen and offers suggestions what to do about it. Independence has an economic basis that is as solid as its political foundation is fragile, because central banks are unelected power. And in the realm of economics and politics, the political economy of central banking may help us understand the evolution of the degree and the specific form of independence because of both internal and external political and economic constraints. The paper examines these issues in some detail, to contextualize the economic and non-economic threats to independence and discusses possible mitigants. Properly assessing the challenges is a prerequisite for preserving the value of this institution, which is perhaps the most important and effective institutional innovation of our time in macroeconomic policy.

Keywords: Central bank independence, Monetary economics, Independent regulatory agencies, Political economy of monetary policy.

JEL Classification: E4, E5, D78, G28.

1. Introduction. Whither central bank independence?

Since the creation of the first central bank, the precursor to Sweden's Riksbank, in 1668, central banks have generally enjoyed a certain halo of prestige. Their reputation has been

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occasionally somewhat exaggerated, as reflected in the famous quip attributed to the unrestrained comedian and unsuccessful US presidential candidate in 1928, Will Rogers, who said: “The three greatest inventions of all time have been fire, the wheel, and central banking” (Samuelson and Nordhaus, 1992, 524). Indeed, the technocratic nature of central banks, removed from the day-to-day of politics, as well as their key role in pursuing economic stability have contributed to this image. While there have been historical examples of central bank mistakes or prominent critics of these institutions, such as Milton Friedman (1994), who doubted their necessity, the establishment of independent central banks has steadily progressed over the past half-century.

After World War II, central banks in many countries were gradually nationalized to serve as a coherent instrument of government macroeconomic policy. Starting in the late 1980s, the status of independence became more and more widespread. It is worth noting that before 1980, only five central banks had a significant degree of independence from their governments: the Bundesbank, the Swiss National Bank, the central banks of Austria and Denmark, and the US Federal Reserve.

The golden age of independent central banking extends over the two decades ending in 2008. The worldwide boom experienced during this period can be understood as the culmination of two macroeconomic consensuses that had been shaping since the late 1960s: 1) There is no long-term tradeoff between inflation and unemployment; and 2) Attempts to reduce unemployment below its natural rate, as frequently observed prior to elections, create an inflationary bias and macroeconomic volatility, which deteriorates social welfare and undermines the credibility of monetary policy. This is the problem of time inconsistency, which I will discuss further later. It provides the basic economic rationale behind the independence of central banks, understood as the most suitable institutional mechanism for ensuring price stability. According to the new consensus, endowing the central bank with independent decision-making authority over the use of monetary policy instruments, with a mandate for price stability, enhances the effectiveness of monetary policy and reduces the inflation volatility.

Thus, the independence of central banks, actively promoted by international organizations such as the International Monetary Fund (Pistoresi *et al.*, 2017) and economic integration initiatives, like the European Monetary Union, became almost universal and established itself a pillar of the so-called Great Moderation, a three-decade period characterized by moderate inflation, economic dynamism, and low macroeconomic volatility. Despite the favorable winds of globalization and the advances in information and communication technologies, as well as some measure of good luck (Miles *et al.*, 2017), no one disputes the relevance of the role played by central banks in this long period of prosperity and economic stability (Clarida *et al.*, 2000).

And just when many economists believed they had found the secret to perpetual stability, in an arrogant sentiment that finds its parallel in Fukuyama’s “end of history” (Fukuyama, 1992), the Global Financial Crisis of 2008 arrived, with its trail of deep recession and financial collapse. Was the Great Moderation a just Great Illusion, which called into question the role and independence of central banks? It is perhaps not surprising that populist politicians like Re-

cep Tayyip Erdogan, Donald Trump or Liz Truss have hindered the autonomy of central banks or attempted to interfere with it. But when reputable economists such as Charles Goodhart, Willem Buiter or Guy Debelle state that independence "was good while it lasted" (Goodhart), that "it is a product of its time" (Buiter) and that "it is unlikely to survive much longer time" (Debelle) (Bank of England, 2017), a deeper reflection is in order. Although none of them proposes reintegrating the central bank into the Treasury, these provocative statements reflect discontent both with the role of central banks in the years leading up to the crisis and with some of their interventions to address it, as well as the subsequent expansions of their mandates.

Criticisms of the once almost sacrosanct independence have arisen in spite of the dominant recognition that central banks "saved the world" from repeating the Great Depression of the 1930s. Indeed, the individual and sometimes coordinated intervention of the European Central Bank (ECB), the Federal Reserve, the Bank of England, the Bank of Japan and the Swiss National Bank, among others, was referred to as "the only game in town". Over time, however, central banks have taken on new responsibilities, such as financial supervision, which brings them closer to the political sphere, or have expanded their balance sheets, which has had significant distributional effects, or engaged in other tasks, such as contributing to accelerate the energy transition. And although the vast majority of central bank governors, 62% of those surveyed by Blinder *et al*. (2017), do not perceive any threat to independence in the future, this opinion is in the minority among academic economists, at 13%, in a context where criticism has increased, particularly in the countries most affected by the crisis. The sharp inflationary episode that began in the spring of 2021 and that is expected to persist, albeit more moderately, until 2025, has only fueled censure of central banks' ability to fulfill their primary mandate (Buiter, 2023).

In light of this divide and the recent assaults on independence, it would be unwise for central bankers to sit in their laurels. Protecting central bank independence from its enthusiasts demands a re-examination of the intellectual underpinnings of independence beyond the pure economic arguments, which broadly preserve their validity today. Because independence has an economic foundation that is as solid as its political basis is fragile, by pure construction, because central banks are unelected power, and the legitimacy of exercising their power must be grounded in principles and practices distinct from democratic election. And lying midway between economics and politics, the political economy of central banking helps understanding the evolution of the degree and the specific form of independence because of both internal and external political and economic constraints. This paper examines these issues, to contextualize the economic and non-economic threats to independence and discuss possible mitigants. Properly assessing the challenges is a prerequisite for preserving the value of this institution, which according to Kenneth Rogoff, is perhaps the most important and effective institutional innovation of our time in macroeconomic policy.

2. A bit of political economy

Let us start the analysis by posing a question whose answer is not trivial: Why would the political power willingly accept to tie its hands by granting independence to the central bank?

This would only be politically rational if the government concluded that voters and markets expect that, despite its sincere promises, the executive branch will use monetary leverage for purposes other than or unrelated to price stability. For example, to favor close interest groups or specific sectors with privileged financing. Or to secure less burdensome deficit financing for themselves through low interest rates and debt placement with the central bank. Or to boost the economy with short-term monetary stimuli, particularly nearing elections. As a result, the announced objectives of price stability by a government exercising discretion over monetary policy are not credible to the population and for financial agents. This leads to an inflationary bias and an inflation risk premium that the markets discount and citizens, who are ultimate voters, deplore. This phenomenon of lack of *ex-ante* credibility of policy announcements, which determines their *ex-post* failure, is referred to as the "problem of time inconsistency", first formally analyzed by Kydland and Prescott (1997).

There are several institutional solutions that monetary theory has offered address this problem. One of them is the so-called "monetary rule" of Friedman (1959). It involves a non-contingent rule for the growth of money supply that can accommodate the growth of nominal output. Such a rule, which eliminates the discretion of monetary policy, can be enacted by law and does not even require a central bank. "We could replace the Federal Reserve with a computer that would calculate each month how much money should be printed" (Friedman, 1994). It goes without saying that such a rule can have significant costs in the face of changes in the velocity of money circulation, shifts between components of different monetary aggregates, lack of flexibility in the face of major economic shocks, or lack of credibility in adhering to the rule itself.

A softer version of a rules-based monetary policy is provided by Taylor's proposal (Taylor, 2011) to require the Federal Reserve by law to make explicit a rule to be followed connecting the policy rate, inflation and economic activity, such as the so called "Taylor rule" (Taylor, 1993). Deviations from the rule in extraordinary circumstances should be subject to reinforced accountability. There are no central banks that follow monetary rules, although for some periods and countries, central banks' policies adjust well to the "Taylor rule".

Another possibility, open to a non-independent central bank, is based on reputation (Briault *et al.*, 1996). Through its public communication (lectures, inflation reports, etc.) and its actions, a central bank can reveal information and build an anti-inflationary reputation. A good example is the Bank of England before 1996, when it gained independence. The reputation solution requires some informal delegation of authority, is vulnerable to potential government interference, and may not be feasible for central banks with have low initial credibility.

A third solution to the problem of time inconsistency is the signing of a contract between the government and the central bank (Walsh, 1995). The contract would specify the inflation target and a structure of incentives and penalties, granting the central bank complete discretionary decision-making authority for this purpose. It should be noted that the optimal contract resolves the problem if we assume that the government has the credibility to honor the contract when inflation exceeds the target. New Zealand has implemented this formula, with penalties that can lead to the dismissal of the governor.

In an influential article, Rogoff (1985) proposed the alternative approach of appointing a governor with conservative preferences on inflation, granting him complete freedom to implement the necessary measures to achieve his objective. This represents full *de facto* independence of the central bank without the corresponding accountability. There are few examples that fit this model, with the relevant exception of the Bundesbank before 1998.

In view of the drawbacks of all these options, since the late 1980s the international consensus has crystalized around a fifth alternative, which consists of the following elements: 1) A price stability mandate, which is sometimes delegated in detail to the independent central bank itself, as is the case with the ECB; 2) Strengthened independence of the central bank in the operational and functional, personal, institutional and financial dimensions; and, 3) Requirements for broad transparency, necessary for both accountability and greater effectiveness of monetary policy.

To sum up, the lack of credibility of governments in producing the public good of price stability and society's aversion to inflation, which reached very high levels in the 1970s and late 1980s, explain the emergence of independent central banks as the leading institutional solution. However, these reasons do not fully explain the rapid spread of this model worldwide. Significant contributions to this extension came from the demands of the financial sector and central bankers, international organizations and the academic community at large. But there where also political factors at play, such as the appeal of tying the hands of the opposition, to prevent political competitors from using monetary policy to their advantage in the future, as well as the introduction of a desirable option to scapegoat the central bank in crisis situations.

3. *De iure* independence and its effects: Measurement and empirical evidence

The degree of independence differs significantly among countries and has changed over time. In order to establish comparisons and analyze its evolution, as well as to empirically test the effects of independence on inflation and other macroeconomic variables, and to analyze the determinants of the degree of independence assigned to a particular central bank, it is necessary to codify and quantify the different dimensions of independence in one index. Generally, the indices available refer to legal or *de iure* independence. Although *de facto* independence is the variable of interest, measuring *de iure* independence matters first because it is a primary determinant of effective independence, and second because it reflects the concrete will of the legislator.

The most complete and robust indices of independence are those elaborated by Grilli *et al*. (1991), Cukierman *et al*. (1992) and Romelli (2022). Romelli's index includes six dimensions: 1) Provisions on the appointment, term, qualifications and removal of the governor and other members of the bank's board; 2) Responsibility for monetary policy and resolution of conflicts with the government; 3) Objectives assigned to the central bank; 4) Limitations on lending to the government; 5) Financial independence; and 6) Obligations of information and transparency. These dimensions are subdivided into 42 sub-indices, each assigned values between 0

(minimum independence) and 1 (maximum independence). For example, if the governor is appointed by the central bank's own council, the score is 1, and 0 if he is appointed by the finance minister. If this appointment is for 8 or more years, the score is 1, and 0 if the term is less than 4 years or if it is at the discretion of the appointing authority. Regarding objectives, a higher index is given to a central bank that has price stability as its sole objective compared to one that has multiple mandates, which may lead to conflicts. Maximum scores are given to the prohibition of lending to the government, or the guarantee of automatic recapitalization of the bank at its request. Once the six dimensions are computed, they are added with equal weights into a single index. Other indicators weigh more heavily the conditions affecting the governing bodies (for example, Grilli *et al*., 1991), or the limits on lending to the government (for example, Cukierman *et al*., 1992), which is always a subject of controversy. In practice, the weights have proven to be of secondary relevance, as the different dimensions of the index tend to be correlated.

From Romelli's work, it can be inferred that independence increased noticeably at the international level since the late 1980s and reached its peak in the mid-1990s, particularly in the dimensions of central bank governance, inflation targets, transparency and accountability. And by geographic area, developed Western economies clearly led the way, closely followed by East Asia-Pacific nations.

Once we have measures of independence, we are able to assess to what extent this characteristic is associated with better macroeconomic outcomes. The empirical literature on this topic is extensive (see, for example, Dall'Orto *et al*., 2020). The most recent and rigorous part of it, in the sense that it carefully addresses econometric issues such as the endogeneity of the independence measures, sample sizes, and spatial and temporal heterogeneity, allows us to conclude the following (see Masciandaro and Romelli, 2020, and Garriga and Rodríguez, 2020): 1) Independence of central banks, in both developed and developing countries, and even in autocratic countries, significantly reduces inflation; 2) All dimensions of independence contribute to this result; and, 3) This inflation-reducing effect is moderated in the later years of the 2010s, a period of very low inflation, although the significance of its impact remains.

It is worth asking whether the beneficial effect of inflation control has come at a cost in terms of output volatility. The available evidence indicates that these costs may have existed in some cases, although there is no significant connection with the degree of central bank independence (see Cecchetti *et al*., 2016; Bogari, 2020; and Garriga, 2016). Furthermore, although some authors find a positive association between central bank independence and various indicators of financial liberalization, which suggests a connection between independence and financial distress (for example, Aklin and Kern, 2020), there are no empirical indications of a direct and significant cost to financial stability. On the contrary, also because central banks usually have a role in financial supervision (see Masciandaro and Romelli, 2018), greater independence tends to be associated with a reduction in systemic risk, especially during banking crises (see Fraccarolli *et al*., 2020; and Nguyen and Dhan, 2022).

Based on the evidence, it appears that this institutional creation has been a resounding success. But this conclusion must be nuanced for at least two reasons. First, high *de iure* independence could mask lower *de facto* independence. And second, it is necessary to explain

why some countries make more progress than others in granting independence to the central bank, when the benefits seem so evident. The following two sections elaborate on these issues.

4. *De facto* independence: The reaction of politics

An independent central bank reduces the power of the executive and often delivers news that politicians loathe in the short term, such as rate hikes before elections, or the declaration of insolvency of a bank, which may require the use of public resources. The temptation to limit independence is always present. The most direct way to do this is by reducing the level of *de iure* independence. However, this can have high political costs in strong democracies. An illustrative recent case is that of Liz Truss, the short-lived British Prime Minister, whose government program in July 2022 included a review of the Bank of England's independence charter to include government guidance on interest rates. She had to retract this idea in September, as did her successor Rishi Sunak (see Gilles, 2022; and Parker, 2022). But other initiatives have prospered, such as that of the Reserve Bank of New Zealand, promoted by the populist New Zealand First party, which includes changes such as multiple objectives (low inflation, high employment, and curbing housing costs!), as well as *de facto* limitations on qualifications for board members (macroeconomics professors are ineligible in the name of avoiding conflicts of interest!) and a heavy responsibility of the minister of finance in all the appointments (see Binder, 2020; and Wilkinson, 2023).

The case of Turkey contains the elements of a siege in all fronts. Since 2016, the central bank has had no less than six governors. The last appointment was that of Governor Erkan, on June 9, 2023. It is noteworthy that until 2019, the legal term was for five years. In May 2018, President Erdogan publicly declared his willingness to take responsibility for monetary policy. In July of that year, by presidential decree, he assumed the authority to personally appoint the governor, deputy governors, and the other members of the Monetary Policy Committee. In July 2019, he dismissed the governor by decree and reduced the central bank's ability to bolster its reserves from profits from 20% to 10%. In August 2019, the chief economist and other senior bank officials were fired. In 2020 he again dismissed the governor after he raised the interest rates and eliminated the requirement of 10 years of relevant professional experience for candidates to the position of deputy governor. And again, in March 2021, the governor was fired for raising interest rates (see Reuters, 2020, 2021). It is worth noting that annual inflation grew from almost 10% in September 2019, to 85% in October 2022, currently standing at around 60%. Argentina and India also offer recent examples of serious erosion of independence (see Dall'Orto *et al*., 2020).

The cited cases have not been the norm in recent years, so legal independence indices have varied little from high levels. However, *de facto* independence has suffered erosion (see Romelli, 2022). For example, through the practice of appointments to bank's board, increasingly populated by people with strong political backgrounds. This has occurred in Turkey but also in other nations, including some advanced countries, where it has not been uncommon for former ministers of economy or finance to be directly promoted to the central bank. Furthermore, a legislative change is not necessary to force the resignation of the governor

with sufficient pressure. This circumstance has led some authors to consider the frequency of governor changes as a proxy for lower *de facto* independence. Cukierman *et al*. (1992), as well as Iksan and Konishi (2022), find a statistically significant positive relationship between the frequency of governor changes and the inflation rate, at any level of *de iure* independence. These results are corroborated by Cukierman and Webb (1995) using a political vulnerability index, which represents the probability of a governor's resignation within the first six months of a change in the ruling party or political coalition. Similarly, Vulletin and Zhu (2011) confirm that the anticipated replacement of a governor with someone politically close to the government has a significant impact on the inflation rate.

De facto independence may also suffer as a result of political pressures and criticisms, as they impinge on the credibility of the central bank. Binder (2021a) codifies and analyzes these public pressures on a total of 118 central banks using language analysis methods applied to quarterly databases from 2010 to 2018 from the *Economist Intelligence Unit* and *Business Monitor International*. In over 90% of cases, the pressures were aimed at achieving lower interest rates or delaying the publication of relevant statistics. The analysis distinguishes between cases where the central bank resists and those where it succumbs. One key finding is that political pressures are orthogonal to the degree of *de iure* independence, meaning even the most independent central banks experience them. The study provides evidence that pressures have a significant impact on inflation, especially when the central bank succumbs to them, but also, to a lesser extent, when it resists. The tendency to pressure the central bank is significantly lower when the executive branch is politically centrist, and higher when the governments are nationalist or populist in nature, or when democratic quality is low (i.e., limited electoral competition or weak checks and balances). Another interesting result is the importance of public statements from international organizations: a recommendation from the International Monetary Fund (IMF) regarding central bank independence significantly reduces the likelihood of subsequent political pressures.

5. Political economy of *de iure* independence

Thus, politics is present both at the origin of *de iure* independence of the central bank and in its *de facto* erosion. Empirical literature on the political economy of central bank independence has focused, among other issues, on explaining the factors that condition the political decision to grant greater or lesser formal independence to the central bank. What is the politically optimal degree of independence from government? Masciandaro and Romelli (2015) develop a simple model with two types of agents: the citizens, who detest the discretion of the government in monetary policy, familiar from experience of the inflationary bias it generates, and the government. The executive must largely meet the demand for time consistency formulated by the citizens, but at the same time it does not want to completely lose a lever to cheer up the economy, finance the budget with some ease, be able to address problems in the financial sector with liquidity, and accommodate balance of payments shocks.

Consequently, citizens delegate to the government the design of a central bank. To be confirmed in a democratic process, the executive must align its objectives with those of the voters,

but not perfectly, because the independence of the central bank has two cost elements for the executive: 1) The effort required for its creation –political negotiations, legislative and bureaucratic procedures, budget needs, etc.–, which may vary with the constitution, the electoral system and the government's other political priorities, and is generally lower in societies with a high level of social trust (Berggren *et al*., 2014); and, 2) The risk of being accused by citizens and political opposition of *ex post* incapacity to deal with possible future shocks to employment, the budget, financial stability or the exchange rate, having renounced monetary accommodation .

The theoretical implications are immediate. First, the government will tend to design a less independent central bank than citizens would desire. Second, the government will have less incentive to provide broad independence if the probability of recessions, financial rescue needs, or budget difficulties is high. And third, after a period of low inflation and problems in the financial sector, the degree of independence is expected to decrease.

The legal design of independence is endogenous, and depends on political interactions, economic conditions and institutional constraints. What does the empirical evidence say about this? A recent and ambitious study by Romelli (2022) analyzes around 2,500 legislative reforms in 154 central banks since 1972, which is nearly half a century of observations. Here are its main findings: 1) Countries with an initially less independent central bank tend to introduce reforms to strengthen independence; 2) The introduction or increase in central bank independence generally occurs after periods of high inflation; 3) Participation in IMF programs brings about reforms that increase independence; 4) Regional pressure is a relevant factor: independence tends to be introduced or reinforced if neighboring countries have highly independent central banks; 5) Joining a monetary union is associated with greater independence; 6) Opening up to the outside world combined with increased economic globalization is correlated with greater central bank independence; 7) The rise of populism linked to nationalism leads to reductions in *de iure* independence; 8) The transition from an autocratic regime to democracy favors central bank independence; and, finally, 9) Financial crises tend to imply losses of financial independence from the central bank. It is interesting to note that neither the size of the public debt nor the foreign exchange or sovereign debt crises are empirically associated to independence.

An implication of these results is that it does not make sense to talk about an economically optimum degree of independence that all countries should strive for because this design might not be feasible or desirable. The perspective of political economy aims to explain the degree of politically rational independence, which balances the benefits of independence –i. e., price stability– with economic, institutional and political constraints. And in the interplay of these political factors –democracy, nationalism, populism, pressure from neighboring countries, or monetary integration agreements– a central and thorny issue underlies, which is the political legitimacy of the central bank.

6. The fragile political legitimacy of independence

There are two seemingly contradictory opinions, those of Milton Friedman and Paul Tucker, which shed light on the importance of the legitimacy of the central bank, a non-elected

power. In the early 60s, Friedman (1962) wrote: "An independent central bank represents the very attractive idea that it is essential to prevent monetary policy from being a plaything at the mercy of political authorities' whims". However, he asked: "Is it tolerable in a democracy to have so much power concentrated in an institution without democratic control?". His answer was roundly negative, advocating instead for a law that would set a rule for monetary growth.

Tucker, a former deputy governor of the Bank of England, and currently a professor at Harvard, argues, on the other hand: "Under fiat money, independence of the monetary authority is a corollary of the higher-level separation of powers between the fiscal authority of the legislature and the elected executive government: if the elected executive were to control the monetary levers, it would have the power to tax (money) through episodes of unexpected inflation. Central bank independence is, therefore, grounded in the values of constitutional government" (Tucker, 2018, part IV). What justifies independence? Tucker's answer: "(The fact that) price stability fits with some of our deepest values since it contributes to preserving freedom and, in particular, aims to protect people from the state abusing its monopoly powers over the issuance of money". Needless to clarify, in this conception the central bank is not a new fourth power, since it is subordinate, in different ways, to each of the powers of the state: the legislature, responsible for the delegation of powers and to which it must render accounts, the executive, generally in charge of appointing central bank authorities, and the judiciary, competent to resolve disputes in accordance with the law.

The Achilles heel of central bank independence is the lack of legitimacy of origin: central bankers are not democratically elected. Legitimacy is not transitive: the central bank may be given statutory powers, but not legitimacy. Faced with this weakness, elected politicians frustrated with the loss of influence over central bank decisions may react in two ways. First, they can rescind independence, either partially or entirely. However, this option comes with political costs, which can be very high when independence is enshrined in the constitution, as is the case in the Eurozone, Mexico, Russia or South Africa. And second, they can manipulate appointments, by selecting unqualified or politically close individuals, they can unduly expand the central bank's mandate, or they could resort to public pressure and criticism of the central bank.

Preserving over time the independence of the central bank and its beneficial effects, it must be seen as legitimate, which requires it to be both grounded in and limited by the law. Additionally, it must respect deeply ingrained social values, such as democracy –that is, one person, one vote–, the rule of law, and accountability. Furthermore, its actions must adhere to strict delegation principles, including the following (Tucker, 2018, Appendix): 1) Limiting the core mandate of the central bank to the objective of price stability; 2) Expanding the mandate, where appropriate, to those tasks intrinsically linked to monetary stability, such as banking and financial stability; 3) Exercising restraint in any other public policy activities (for example, the fight against climate change); and, 4) Proceeding with maximum transparency compatible with effectiveness, always in service of accountability.

Transparency has two essential effects on the performance of central bank functions. First, transparency in the economic dimensions –such as the dissemination of economic information and forecasts– and operational dimensions –related to the monetary transmission

mechanism– enhances the effectiveness of monetary policy, by improving forecasts and guiding private sector expectations (Crowe and Meade, 2008). And second, and most importantly, all aspects of transparency, including the political dimensions –clearly codified objectives– and procedural dimensions –immediate dissemination of the decisions, explanation of these through press conferences, publication of minutes and voting results, etc.– are essential ingredients of the accountability that legitimizes independence. Alan Greenspan, referred to as *The Maestro* before the Great Financial Crisis, once stated before a Senate subcommittee (Greenspan, 1987): "If I seem unduly clear to you, you must have misunderstood what I said". This quip is the antithesis of what transparency demands. Similarly, the irritation expressed by the British MP Mudie at Mervyn King's interventions reflects the sentiment of frustration at abstruse communication: "All we can is ask simple questions and listen to your very erudite explanations... What good is that sort of accountability to elected politicians?" (cited in Tucker, 2018, ch.31, p. 2). The era of opacity and erudition must give way to one of transparency, with differentiated languages for different audiences –from economic bulletins, press conferences, parliamentary appearances, and publication of minutes, to modern blogs and other media used, for example, the ECB– if the effectiveness of monetary policy and accountability are to help establish the legitimacy of the central bank.

Political scientist Maggetti (2010) argues that, in the absence of democratic legitimacy, independent central banks must seek legitimacy from external sources, such as performance and accountability. Performance is not always perfect, due to policy errors or extraordinary shocks, and in some scenarios good results can only be achieved through quasi-fiscal measures with a high redistributive impact. The role of accountability becomes thus essential. This exercise of responsibility can be carried out in three ways, or in three directions: 1) Top-down, before the democratically elected principals: government and parliament; 2) Bottom-up, before interest groups and the public; and 3) Horizontally, through the membership of central banks in transnational networks –such as the Eurosystem or the Bank for International Settlements– as it provides reciprocal pressure for stricter procedures, stimulates mutual learning, and strengthens protection against external influences.

In conclusion, lacking legitimacy of origin, the social sustainability of central bank independence must be based on a delegation process structured by law, conformity with democratic values, the technical capacity of the central bank, effectiveness in relation to its mandate, and accountability. But in the real world things are not so simple, as the Great Financial Crisis proved.

7. Recent criticisms of independence

The severe crisis that began in 2008 brought about significant changes in the behavior of central banks which, while acknowledged for potentially saving many countries from falling into depression, are now subject to critical interpretation by many. Central banks undoubtedly became very powerful, to the extent that they may have encroached into areas that are not their own, such as redistribution or fiscal policy. It can be argued that central banks did what was necessary. But necessity is both the mother of invention and, at times, the seed of decay.

Perhaps the most serious criticism is the incursion of central banks into the realm of quasi-fiscal policies with significant redistributive impacts. This was not deliberate but rather an unintended consequence of the need to repair the transmission mechanism of monetary policy. As a result of the subprime and the sovereign debt crises, important segments of the financial markets ceased to function. Subsequently, when interest rates approached their lower limit ("zero lower bound"), central banks decided to purchase large amounts of public and private debt to counter the risk of deflation. However, quantitative easing is, in effect, equivalent to public debt management, which falls under the purview of governments. Moreover, near-zero or negative interest rates benefit government and private debtors, at the expense of older generations and the banking system and its shareholders. Could central banks have prevented this without deviating from their price stability mandate? Probably not entirely. Legal, political or financial constraints prevented governments from acting to the extent and with the speed required. Should central banks have remained idle and refrained from implementing "unconventional policies"? Surely not, as that would have been an abdication of their responsibility to fulfill their mandate. However, while the redistributive and fiscal effects of monetary policy are second order in normal times, they can become very significant during severe crises, even if the measures taken are temporary. One way to attenuate these criticisms would be to establish reinforced mechanisms of *ex ante* transparency and *ex post* accountability for central banks *vis-à-vis* their key policy-makers during times of crisis, without compromising their independence, as suggested by Jones and Matthijs (2019).

There has also been criticism of the appearance of unwarranted accumulation of discretionary power. For those favoring rules as opposed to discretion, more than formal independence, central banks need to stick to a clear strategy crafted in terms of quantitative rules (Taylor, 2013). Unconventional monetary policy is the radical opposite of this rules-based approach. It is doubtful however that following closely such rules at times of extraordinary financial turbulence –i. e., when the monetary transmission mechanism breaks down starting with a freeze of the money markets– would produce good results in terms of the central banks mandate. In fact, the prevailing consensus is that unconventional monetary policies (negative interest rates, quantitative easing, currency swaps, etcetera) have been quite effective in preventing further financial distress and achieving better outcomes in both inflation and growth (Dell'Ariccia *et al.*, 2018; Kuttner, 2018).

Connected to the issue of excessive discretion is the perception of an undesirable proximity to the political sphere. One example is the negotiations between the Treasury and the Federal Reserve for bailouts. Another illustration is the participation of the ECB in the *troika* responsible for establishing the conditionality of the rescue programs for Greece, Portugal, Ireland and Spain. While it may have been difficult to avoid in the absence of a European framework for intervention in sovereign crisis situations at that time, this activity by the ECB was an anomaly that weakened somewhat the bank's image and contributed to frustration and resentment (Jones, 2019). According to the survey by Blinder *et al.* (2017), only 4% of central bank governors think that independence has been lost because of potentially crossing the line into politics, compared to 45% in the opinion of academics. This dissonance should not be overlooked, for two reasons. First, because crossing the line in one direction invites crossing it in the opposite way, that is, political meddling with the decisions of the central bank.

And second, it fuels the attacks of populist movements of all stripes towards "these overly powerful entities, governed by and for the elites". As we have seen, these pressures weaken the effectiveness of the fight against inflation and could tempt some central banks to use their immense financial and technical capabilities in the service of "the people": quantitative easing for the people, helicopter money, and similar initiatives (for a critique of these measures, see Borio, 2019). Binder (2021b) has referred to this as the "techno-populist temptation", which could exacerbate rather than resolving issues of legitimacy and democratic discontent.

A third widespread criticism relates to the expansion of central bank mandates, either imposed by governments through legislation or unilaterally pursued ("mission creep"). Here, a distinction must be made between responsibilities that are intrinsically related to the price stability mandate and those that are not (for a detailed discussion, see Balls *et al*., 2018). Price stability requires monetary stability, which includes the stability of the value of money issued by the central bank and also the stability of the value of bank deposits in terms of central bank money. This implies that central banks have a natural interest in bank supervision as lenders of last resort (see González-Páramo, 2013), and in financial stability (Schinasi, 2005). Hence, competencies in banking supervision and macroprudential supervision should be assigned, at least in part, to the central bank, especially when measures are put in place to mitigate potential conflicts of interest. The absence of sufficient supervisory powers considerably reduced the ability to address the Great Financial Crisis.

However, it is a different matter to attribute to the central bank objectives that belong entirely to the realm of government policies, such as redistributive policies. Another current controversial example is climate change, a matter of immense gravity and with profound economic and financial implications (for instance, González-Páramo *et al*., 2024). It is evident that its effects on inflation are of interest to monetary policy and banking supervision, and thus should be incorporated into modeling and stress tests. However, it is debatable to what extent it should it be a priority for the central bank to interfere in the market to correct climate related aggregate externalities by "greening" its portfolio of own funds or its bond-buying or collateral policy, as announced by the ECB (see ECB, 2021, and Lagarde, 2022), at the potential expense of market liquidity or the smooth functioning of the monetary transmission mechanism. The ECB should contribute to the general policies of the EU, without prejudice to its primary mandate. And governments should be at the forefront of measures to combat climate change, in the same way they are in charge of structural, labor and other policies. There is no time consistency problem here, nor does the qualification of an independent central bank give it any particular advantage. As Elderson (2023) points out, central bankers and supervisors are not designers of climate and environmental policies, but rather policy takers in this space.

Finally, another front of criticism against central banks over the last decade is based on the difficulties they have encountered in fulfilling their core mandate. Prior to the pandemic, the major problem was very low or even negative inflation. Since the spring of 2021, as a result of the post-pandemic recovery and the invasion of Ukraine, we have seen inflation reach levels not seen in four decades. For a central bank that largely derives its legitimacy from outcomes, this situation represents a significant vulnerability. This once again highlights the

importance of transparency and accountability. The consequences of the deep financial crisis during the past decade and the extraordinary and successive supply shocks during the current one can be explained to political power, citizens and markets, without neglecting to acknowledge errors in assessing inflation as temporary, as has been the case for most central banks during 2021 and the beginning of 2022 (see Schnabel, 2022). There could have been improvements with more proactive communication of risks or more expert judgment and enhancements in modeling, but it is doubtful that a lesser degree of independence and more government intervention could have achieved superior results.

8. Back to principles

For years central bankers nurtured an aura of masters, charismatic celebrities, priests in the service of monetary stability. The dubious end of Alan Greenspan's career represents the obituary of a way of understanding the profession. As a matter of fact, the central bank is nothing more than an independent agency, operating with powers delegated by the legislature upon the initiative or with the agreement of the executive branch. The governor and the members of the governing bodies vote on monetary policy, but they are not democratically elected; rather, they must be qualified for the position. This obliges them to operate within strict democratic norms and be accountable. Can it be asserted that this model is no longer justified, as Summers suggests (Summers, 2018), or lacks a future, as implied by Goodhart, Buiter and Debelle (Bank of England, 2017)?

None of the above analysis supports these claims. Obviously, inflation is not dead. We are witnessing its resurgence since mid-2021. Price stability is a public good that society can only enjoy if the problem of time consistency is addressed, and there is no better institutional mechanism for this than an independent central bank, detached from the day-to-day of politics. At the same time, however, the experience from the Great Financial Crisis to the present has provided fundamental lessons for the social sustainability of central bank independence. And it is not so much a matter of introducing changes in the degree of *de iure* independence –which in fact has not changed much since the crisis, according to most indices– but of attitudes and the way of interpreting the principles. In this regard, I will conclude with four reflections on the central bank's mandate, other dimensions of independence, accountability, and the institution's social projection.

The fundamental mandate of the central bank should be to ensure price stability in the medium term. In performing this task, the bank indirectly contributes to achieving other social objectives, such as ensuring a high level of employment in the medium term. The mandate must be specified in simple terms that are understandable to everyone. There are missions aligned with the mandate, such as banking and macroprudential supervision, in which the central bank must play a relevant role, without prejudice to the autonomy of its decisions, as deprived of banking and financial stability the monetary policy transmission mechanism ceases to function. Expanding the mandate beyond these missions –except subsidiarily– risks jeopardizing the effectiveness of the central bank in its primary mission of maintaining price stability.

Regarding other dimensions of independence, the experience since the financial crisis allows us to point in two directions. First, the personal independence of the governor and other members of the governing bodies should receive more attention from those responsible for their selection. Excellent qualifications, political independence, and sufficiently long and non-coincident terms of office with political turnovers are prerequisites for the success of the central bank. And second, the financial independence of the central bank should be strengthened by introducing effective statutory bank recapitalization mechanisms ready to be activated when the bank incurs losses as a result of its monetary policy operations. This would both protect central banks' financial and operational autonomy and avoid negotiations with the government that could, at the very least, damage the perception of independence.

Accountability and communication with stakeholders –government, parliament, markets and citizens– are the key to the central bank's legitimacy, over and above its success in controlling inflation at a given point in time. Relying solely on good outcomes for social support of independence makes the bank vulnerable in times of difficulty in maintaining inflation close to target. Accountability allows for an explanation of the success or the non-fulfillment of the core mission, as well as the risks to price stability. It should be rigorous and, at the same time, formulated in terms accessible to each of the stakeholder groups. When the bank is assigned additional missions, accountability should be provided for each mission. And in times of deep crisis, when it can severely affect the transmission mechanism and push the bank to adopt measures with significant redistributive or quasi-fiscal effects, accountability should be strengthened as necessary to ensure a proper understanding of their inevitability and temporary nature, without prejudice to autonomy within the legal framework.

Lastly, regarding the social projection of the institution, it is imperative for the central bank to persevere in an ethic of responsibility and self-restraint, while also investing effort in constant improvements in communication. The image of institutions that are excessively powerful, with virtually unlimited funds to address all conceivable problems, ready to fill the voids left by governments subject to legal or political limitations in taking quick action, is not unrelated to a certain erosion of social and institutional support for the independence of central banks. The echo of a certain hubris revealed by the survey of central bank governors by Blinder *et al*. (2017) is at odds with the nature and delegated mission of an independent agency entrusted by law with the primary objective of ensuring price stability. As a side benefit, self-restraint also helps to curb the risks of capture by political and private interests.

In closing, the independence of the central bank has rendered great services to our societies, but it is still too early to consider it fully incorporated into the fabric of our democratic institutions. That is why it is good to debate it, to criticize or to support it, and, above all, to understand its implications and demands, as this is inherent to the legitimacy of one of the greatest institutional innovations of the last half-century.

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Resumen

El problema de la inconsistencia temporal proporciona el soporte económico fundamental de la independencia de los bancos centrales, entendida ésta como el mecanismo institucional más adecuado para asegurar la estabilidad de precios. Según el consenso que surgió en las décadas de 1990 y 2000, dotar al banco central de autoridad independiente para la toma de decisiones sobre el uso de instrumentos de política monetaria, con un mandato para la estabilidad de precios, mejora la efectividad de la política monetaria y reduce la volatilidad de la inflación. Puede resultar sorprendente que las críticas a la independencia, antes casi sacrosanta, surjan después de la Gran Crisis Financiera, cuando se reconoce ampliamente que los bancos centrales "salvaron al mundo" de repetir la Gran Depresión de la década de 1930. El artículo trata de explicar las razones por las cuales han surgido estas grietas en el consenso y ofrece sugerencias sobre qué hacer al respecto. La independencia tiene una base económica tan sólida como frágil es su fundamento político, porque los bancos centrales son poderes no electos. Y en el ámbito común de la economía y la política, la economía política de la banca central puede ayudarnos a entender la evolución del grado y la forma específica de independencia debido a las restricciones políticas y económicas tanto internas como externas. El artículo examina estos temas con cierto detalle, para contextualizar las amenazas económicas y no económicas a la independencia y discute posibles mitigantes. Evaluar adecuadamente los desafíos es un requisito previo para preservar el valor de esta institución, que es quizás la innovación institucional más importante y efectiva de nuestro tiempo en política macroeconómica.

Palabras clave: independencia del banco central, economía monetaria, agencias regulatorias independientes, economía política de la política monetaria.

Clasificación JEL: E4, E5, D78, G28.