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'Independence' of Central Banks and the Political Economy of Monetary Policy

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ABSTRACT

The notion of an 'independent' central bank has dominated monetary policy debates for the past three decades. The arguments for the political independence of central banks are closely related to the adoption of 'inflation targeting'. The arguments for an independent central bank are based on the 'credibility' of the 'conservative' central bank in comparison to government decision making. The independence of a central bank has been a matter of independence from government but not independence from the grip of the 'new consensus in macroeconomics' nor from the interests of the banking and financial sector. That independence has also supported a lack of co-ordination between monetary and fiscal policies, diminishing the effectiveness of macroeconomic policies. In addition, there remain doubts about the effectiveness of 'inflation targeting' on the achievement of low inflation. The policy mandates of central banks have begun to shift towards financial stability and paying attention to issues of inequality and the climate emergency.

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1. Introduction

The idea of the political 'independence' of the central bank has, in many circles, become conventional wisdom over the past three decades, where such independence has been closely linked with ideas of 'inflation targeting' pursued by the central bank through interest rate policy. Section Two briefly considers the notion of central bank independence. Section Three explores the ways in which such independence was based on inflation targeting and the credibility of central banks. The weaknesses of the intellectual framework on which inflation targeting was based are also considered. Section Four deals with the co-ordination of macroeconomic policy when the central bank is independent. Section Five considers the notion of independence and in whose interests central banks operate. Section Six discusses some of the implications of the climate emergency and Section 7 considers inequality in central bank independence and operations. Section 8 concludes.

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2. Remarks on the 'Independent' Central Bank

The idea of an 'independent' central bank has been to the fore in monetary policy debates in recent decades. Central government is generally, though not universally, the owner of the central bank and the central bank serves as the banker of the central government. Central banks have long enjoyed operational independence, and here 'independence' relates to policy-making decisions, notably on the policy interest rate without explicit reference to the government though within the mandate of an inflation target.

The shift towards the independence of central banks has not been universal. Garriga (2016) draws up measures of central bank independence for 182 countries over the period 1970–2012, after discussing the issue of measuring the independence of central banks. This broader data set reveals that, in contrast to previous studies, there have been numerous decreases in the independence of central banks, as well as increases (as illustrated in Garriga's Figure 3). Further, and again in contrast to previous studies that have tended to suggest that central bank independence favours improved economic performance, 'simple analyses show that the associations between CBI and inflation, unemployment or growth are very sensitive to sample selection' (Gariga 2016, p. 849).

A central bank is the bank of the government and the bank of bankers. In its first role, it is responsible for the provision of (initial) finance to the central government. In its second role, it is responsible for the stability and viability of the banking system (and, more generally, the financial system). A central bank has generally been operationally independent of central government in a way akin to the relationship between other publicly-owned corporations. A publicly-owned corporation reports to the government, is monitored through government and parliament, and makes a range of what may be regarded as key decisions, often subject to approval by government. Examples of such decisions are approval of general pricing policy, investment programmes, and closures. It had generally been the case that policy interest rate decisions were made by central government (Treasury) and implemented by the central bank. That relationship changed with the 'independence' of central banks.

As Harcourt, Kriesler, and Halevi (2018) argue, central bank independence means that a major institution responsible for policy is no longer subject to democratic control; the justification for this outcome is either the rejection of representative democracy or that central bank independence is an exceptional case which merits being excluded from democratic processes. The exceptional case made for central bank independence rests on the central bank being more credible than politicians in the pursuit of inflation control and that monetary policy in the form of policy interest rates is an effective way to control inflation.

The arguments in favour of an independent central bank were based on the 'credibility' of the 'conservative' central bank in comparison with government decision making. The independence of a central bank has, of course, been a matter of independence from government but not independence from the grip of the 'new consensus in macroeconomics' nor from the interests of the banking and financial sector.

The arguments in favour of an independent central bank are that different decisions will be made and/or the decisions made will be interpreted differently to those made by central government (usually Treasury) and elected ministers. The information available on economic data and understanding of how the economy works would remain

unchanged (though the shift to inflation targeting reflects moves away from a Keynesian understanding to one more aligned with the new consensus in macroeconomics). The 'conservative' central banker argument is that central banks would place more weight on the reduction of inflation and less weight on the reduction of unemployment. It implies that independent central bankers would tend to set higher interest rates than would government. In turn, this would imply lower levels of economic activity. It is bizarre 'to argue that the government does not have the best interests of the country at heart, while the central bank governors do[; it] implies that the latter have solely altruistic goals, even though they are not answerable to the people' (Harcourt, Kriesler, and Halevi 2018, p. 210).

3. 'Independent' Central Banks and Inflation Targeting

The 'rules versus discretion' literature (Barro and Gordon 1983, for example) advised solving the time-inconsistency problem by placing control of monetary policy in the hands of an independent central bank. Monetary policy was generally framed in terms of control of the money supply, though central banks enacted interest rate policies and were unable to control money supply (however defined) in a bank-created money economy. The time-inconsistency problem (e.g., Kydland and Prescott 1977) arises in so far as a policy declared in one time period to apply in the future may well not be maintained in the next time period.

Inflation targeting (hereafter IT) involves monetary policy being assigned to control/target inflation, with the central bank interest rate as the key policy instrument whereby decisions on policy rates and changes are in the hands of the central bank. This clearly combines two crucial elements; namely, that monetary policy in the form of interest rates is the relevant instrument to control inflation, and that policy rate decisions should be made by the central bank alone (though generally with the caveat of government being able to step in in an emergency such as a financial crisis).

There is a close link between the promotion of IT and the so-called 'new consensus in macroeconomics' (hereafter, NCM).[1] In a highly simplified form, the NCM can be represented by three equations:

$$Y_t^g = a_0 + a_1 Y_{t-1}^g + a_2 E_t(Y_t^g + 1) - a_3[R_t - E_t(p_t + 1)] + s_1 \quad (1)$$

$$p_t = b_1 Y_t^g + E_t(p_t + 1) + s_2 \quad (2)$$

$$R_t = [RR + E_t(p_t + 1) + c_1 Y_{t-1}^g + c_2(p_{t-1} - p^T)] + s_3 \quad (3)$$

where Y^g is output gap; R is nominal rate of interest; p is rate of inflation; p^T is inflation rate target; RR is 'equilibrium' real rate of interest, that is, the rate of interest consistent with a zero output gap, which implies, from Equation (2), a constant rate of inflation; s_i (with $i = 1, 2, 3$) is stochastic shocks; and E_t is expectations held at time t.

Equation (1) is an aggregate demand equation, with the key feature that the real interest rate plays a significant role.

[1]For example, see McCallum (2001) and Meyer (2001) for an introduction, andWoodford (2003) for a very detailed elaboration. See Arestis and Sawyer (2008a, 2008b), Sawyer (2009) and Arestis (2009) for critiques of new consensus macroeconomics and monetary policy.

Equation (2) is a Phillips' curve-type relationship, closely based on a new Keynesian Phillips' curve in which price inflation is related to expected price inflation in a one-for-one manner and the output gap (difference between actual output and potential output). Potential output and the output gap have proven to be problematic,[2] including the movement of estimates of potential output in line with actual output. This is essentially a closed-economy approach, which does not readily incorporate changes in rate of global inflation. It relates to price inflation and acknowledges no changes in relative prices (including between wages and retail prices and between imported prices and domestic prices). It can be contrasted with the 'conflict theory' of inflation whereby both price and wage equations are modelled. For example, in Sawyer (2002), price changes depend on wage changes and adjustment towards a target profit share, and output gap and wage changes depend on price changes, adjustment towards a target real wage and unemployment. Three particular points emerge from this analysis. First, there would be an 'equilibrium' outcome under which price rates and wage changes would be constant (labelled constant inflation level of output, CILO), though there is a lack of market forces which would move the economy towards the CILO. Alongside the equilibrium level of output, there is an equilibrium distribution of income between wages and profits. Second, the CILO (which can be viewed in terms of an inflation barrier) would shift over time through, for example, investment in capacity, and the levels of output and employment consistent with constant inflation would evolve. Third, any control of the inflation rate has to involve more than influencing the level of demand and inflationary expectations.

Equation (3) is often labelled the Taylor rule (Taylor 1999), in which the policy interest rate is set according to the 'natural' rate of interest, the output gap and difference between the target rate of inflation and actual (or forecast) inflation. It can be treated as derived from a loss function in which welfare loss arises from deviations of output from potential output and inflation from target, often in quadratic form (Svensson 1999, 2003). Such a loss function implies that output above potential involves a loss comparable to that from below potential. In recognition of the (negative) relationship between output and unemployment, a view persists that unemployment below 'normal' involves a social loss, and that the social loss from unemployment is on a par with any social loss from inflation.

The arguments supporting an independent central bank are based on the credibility of the central bank, seen from three perspectives. First, in terms of the perceived trade-off between inflation and unemployment, the central bank was argued to be more 'conservative', that is, placing more weight on reducing inflation and less on reducing unemployment, as compared to central government. The central bank would then act in a more disinflationary way as compared to democratic government.

Second, financial market operators and others would have a greater belief in the relevance of interest rate decisions made by the central bank rather than those made by government.

Third, expectations play a key role in the generation of inflation, and the actual rate of inflation is heavily dependent, in a one-for-one manner, on the expected rate of inflation. A government announcing an inflation target combined with strong beliefs that an

[2]See, for example, Heimberger and Kapler (2017), Heimberger (2020) and Sawyer (2019) in Section 8.

independent central bank can and will achieve the target engenders an expected rate of inflation close to the target rate and makes achievement of the target rate easier.

The emphasis on the inclusion of expected inflation amongst the determinants of inflation can be questioned. Rudd (2022), for example, argues that the inclusion of expected inflation

> has occurred with minimal *direct* evidence, next-to-no examination of alternatives that might do a similar job fitting the available facts, and zero introspection as to whether it makes sense to use the particular assumptions or derived implications of a theoretical model to inform our priors. (p. 35)

Yet, part of the argument in favour of IT and central bank independence is that expectations regarding inflation are thereby anchored, and belief in the credibility and ability of the central bank to achieve the target rate of inflation generates expectations that enable the target rate to be reached.

The idea of a 'natural rate of interest' is closely related to a 'loanable funds' approach to interest rates, in which the 'natural rate' corresponds to a rate of interest which equilibrates (ex ante) saving and investment. In more recent times, the 'natural rate' has been taken as a 'neutral' rate of interest with respect to inflation. The natural rate of interest is a property of a specific theoretical approach, and of questionable relevance to the 'real world': '[T]here is no clear indication of how to infer the natural rate of interest … that should be the optimum rate for stabilizing the economy according to the modern theory of central banking' (Levrero 2021, p. 11). Levrero proceeds by surveying the methods used to provide estimates of the natural rate, which essentially are based on some form of averages of past behaviour. He considers the variations of estimate at a point in time arising from different estimation procedures and the movement of estimates over time. Weber, Lemke, and Worms (2008, p. 49) found that 'the usefulness of this concept [the natural rate] for the practice of monetary policy is limited — especially owing to the fact that the natural real rate of interest and its law of motion cannot be measured with satisfying precision'.[3] Similarly, 'some members [of the FOMC], including Greenspan, admit that they have no clear idea what the neutral rate is, but believe they will know it once it is achieved. Presumably, that will occur when price stability is achieved' (Wray 2007, pp. 123–4).

The justification for the independence of central banks often draws on the effectiveness of 'inflation targeting'. Doubts about the effectiveness of inflation targeting follow four lines (see, for example, Arestis and Sawyer 2008c). First, the difference in performance between inflation targeting and non-inflation targeting countries appears small in a general environment where inflation had been declining, and that inflation targeting was often introduced after inflation had been reduced (see also, Angeriz and Arestis 2007, 2008). Ball and Sheridan (2003) compare 20 OECD countries, seven of which had adopted inflation targeting in the early 1990s and thirteen that had not. They find that 'there is no evidence that inflation targeting improves performance as measured by the behaviour of inflation, output, or interest rates' (p. 2). Baumann, Schomaker, and Rossi (2021) note that the idea that inflation is reduced as a result of central bank

[3]Axel Weber was governor of the Bundesbank when this paper was published.

independence has been widely adopted despite 'the ambiguity reported in empirical studies'. They argue that there is only a weak causal link between central bank independence and inflation and 'a strong inflation-boosting impact from introducing central bank independence cannot be ruled out'.

The detrimental effects of inflation targeting are illustrated in Khan's (2022) study. This empirical study compares the economic performance of 30 countries with IT and 29 countries without, focusing on countries drawn from a wide range of income levels. He reports a significant difference of more than 0.5 percentage points in the annual growth rate in the outperformance of non-IT countries compared to IT countries. Further, his 'results seem to convey that inflation targeting may have had a negative impact on the labor market of the adopting countries compared to the non-adopting countries over the sample period' (p. 574). These results suggest that IT, together with the independence of central banks, has a dampening effect on economic activity. A further dimension of the effects of IT is revealed by Altunbas and Thornton (2022), who report results from a panel of 121 countries covering the period 1971–2015, which indicate that adoption of IT 'has been associated with a worsening of income distribution measured by the Gini coefficient and a decline in the labor share of national income relative to the profits share' (p. 19).

Second, variations in the interest rate appear to have little effect on the rate of inflation (though rather more on the level of output). Evidence of this situation is typically obtained from econometric estimation results undertaken within central banks or by those closely associated with them. A 1 percentage point hike in the policy interest rate leads to a significant drop in output but a reduction in inflation of 0.1–0.2 percentage points (Arestis and Sawyer 2004). The OECD (2022) argues, based on simulations, that when interest rates are rising in most industrialized countries around the same time, the negative impacts on output are larger (by one-quarter) and impacts on prices are smaller (by one-half).

Third, there is the attempt to ultra-fine-tune, in the sense that monthly decisions on (and hence potential changes in) interest rates are made to seek IT up to two years ahead. Fourth, there is a lack of strong theoretical link between interest rate and economic activity and inflation. Sawyer (2009) examines a number of these proposed links. The essence of the argument is that the interest rate and the level of economic activity are viewed in *levels* whereas inflation is a *rate of change* (of prices). Thus, a higher rate of interest may lead to lower prices but not falling prices.

4. Co-ordination of Monetary and Fiscal Policies

The IT framework is clearly a one-instrument, one-objective approach. The independence of the central bank and the use of IT have occurred alongside the dominance of monetary policy over fiscal policy, and the absence of co-ordination in monetary policies and fiscal policies.

There have always been those who argue for a broader set of objectives or voice concern for the central bank, including on the basis of unemployment, income distribution and macro-prudential risks.

We would argue that government policies in general should pursue objectives such as low unemployment, less inequitable distribution of income and addressing the climate

emergency. A major question is how far central bank monetary policy can contribute to the achievement of these objectives, and how should they do so. Further, it requires that the mandate of the central bank is changed to reflect those concerns. Arguments in favour of central bank independence based on their credibility and IT do not extend, for example, to addressing the climate emergency.

Central bank independence disables effective co-ordination of fiscal and monetary policy. Indeed, there is a sense in which monetary policy could be used to offset fiscal policy: for example, an expansionary fiscal policy that is perceived to raise demand could well encounter an increase in interest rates. Yet, the central bank has to provide 'initial finance' to enable government expenditure to proceed — and that expenditure has to be financed.

The main argument in favour of central bank independence from both Treasury and politics is to be better able to prevent inflation and stabilize economic activity. According to Bernanke (2008), IT is the best monetary regime because (i) it improves communication between the public and monetary authorities and thus increases agents' capacity to forecast future inflation, and (ii) it disciplines the central bank's monetary policy, thus giving it credibility.

Following the 2008 financial crisis, the usefulness of such co-ordination has been under debate, in particular in relation to lower bound rate policy. Such co-ordination would affect the credibility of monetary policy, giving rise to a private and public debt sustainability problem. In the Geneva Reports on the World Economy 23, Bartsch et al. (2020) stressed the importance of a policy mix in order to ensure that a stimulus policy works effectively. The fiscal and monetary authorities create policy space for each other. They argued that,

> Monetary policy creates fiscal space by keeping borrowing costs low — as a by-product of its forward guidance and measures to influence risk-free rates further into the term structure — and by effectively providing a monetary backstop to government debt, shielding the debt market from potentially disruptive self-fulfilling crises. For its part, the treasury creates monetary space by 'backstopping' monetary authorities. The fiscal backstop protects the central bank from having to run with thin or negative capital if it incurs large portfolio losses from its monetary policy operations. Such insurance thus preserves the central bank's independence and credibility by enabling the significant risk-taking inherent to unconventional monetary operations. (p. 3)

They also argued that using this policy mix would likewise help to increase the natural rate in order to reduce savings and increase investment. They continued that,

> pursuing fiscal deficits not offset by future primary surpluses backed by temporary monetisation (to lift inflation back to target), raising high-quality public spending to take advantage of low borrowing costs, and expanding the supply of safe assets … works only if the central bank can offer a convincing monetary backstop to fiscal policy; and they are effective only if public spending enhances overall investment (possibly exploiting complementarities between private and public capital) and reduces precautionary saving (providing income insurance and addressing unsustainable trends in income inequality). (p. 4)

However, the relationship between the central bank and the government is crucial to stabilize the economy. This relationship results from the government's need for a central bank: the government's spending decision is made first and then credit creation is needed to finance this action (Qanas and Sawyer 2019). Much as central bank

intervention as a lender of last resort is important to the banking sector as a means of achieving financial stability, government interventions are crucial in an economy that faces inherent instability and uncertainty. Government expenditure is important, as an increase in government deficit will lead to an increase in savings, which also leads to an increase in market investment and activities. 'Reinventing' fiscal policy as an active and permanent state intervention to co-ordinate with monetary policy is vital to smooth and contain the inherent instability of the market system (Qanas and Sawyer 2019).

What is at least as important to understand is that government bond issuance is necessary for the central bank in its interest-rate stabilization operations. As a government bond is considered a safe asset, one carrying the Treasury's risk-free rate, it provides an ultimate proxy to value all other market securities in the modern theory of finance. A co-ordinated and expansionary monetary-fiscal policy can restore confidence and reduce risk in the market, which also helps in terms of achieving financial and economic stability. Furthermore, its function as lender of last resort to the government is also crucial to ensure confidence and stability in the economy.

To allow for such co-ordination, central bank independence should be regarded as operational independence but not goal independence. Accordingly, a central bank that issues money and manages government debt and reserves should accept responsibility for the government's needs and goals, yet it is still crucial to see them in an active partnership rather than one consolidated public entity (Lavoie 2010).

5. In Whose Interests?

Central bank decision making, particularly within an IT framework, is often presented as a technical exercise using the policy interest rate in pursuit of the inflation target. It is, however, pertinent to ask who the effective decision-makers are and in whose interests decisions on interest rates will be made. Epstein argues 'that the notion of central bank independence is a misnomer: usually central bank independence from government implies central bank dependence on the financial sector' (Epstein 2019, p. 391).

Those who make decisions on interest rates within a central bank (and more generally) typically represent and/or are closely linked with banking and finance. In the case of the European Central Bank (ECB), the decision-makers are representatives of member banks; for the Federal Reserve, they are politically appointed federal governors and Federal Reserve Bank presidents; and for the Bank of England, are internal members of the bank and nominated outsiders (usually economists). There is a conspicuous absence (or limited presence) of anyone linked with or representing the interests of workers, consumers and so on, and indeed even of 'industry'. As Levy (1995/96) argues,

> allowing an independent group of men and women to weight trade-offs and make choices that deeply affect the lives of the citizenry is antithetical to democracy when some of them, the regional Federal Reserve Bank presidents who serve on the Federal Open Market Committee, are appoints by boards of directors who are largely elected by bankers, not citizens. (Levy 1995/96, p. 190)

In a similar vein, Wray (2007, p. 121) argued that the members of the US Board of Governors 'are political appointees who bring their ideologies with them to Federal Open

Market Committee (FOMC) meetings'; in decision making 'there is a strong bias against the interests of workers in favor of those of entrepreneurs' (p. 121).

Pixley (2014, p. 101) argues that central bank independence 'runs the risk of replacing the short-termism of politicians, by dependence on the short-termism of financial market pressures'. 'Central bankers' concern with their reputation profoundly influences their actions as is obvious from Pixley's interviews with central bankers and members of the financial sector' (Harcourt, Kriesler, and Halevi 2018, p. 214).

Epstein and Schor argued that,

> in most cases the major function of central bank independence was to keep monetary policy out of the hands of labor … . Where industry and finance were highly divided, as they often were in the UK and the US, central bank independence often served to keep monetary policy out of the hands of industrial capital as well. … In this case, central bank independence tended to give disproportionate power to finance or, as Keynes called them, the 'rentier interests'. (Epstein 2019, p. 392)

Seccareccia (2017, p. 342) seeks 'to describe how central banks have served primarily these … owners of intangible assets, particularly since the global financial crisis of 2008':

> [A]s much as important rentier asset managers have shifted their concern from primarily targeting high returns to preserving asset values for their owners, the same can be said of monetary policy before and after the global financial crisis. … However, after 2008, while not officially abandoning inflation targeting, the focus of monetary policy abruptly shifted from sustaining high returns on financial capital to largely preserving the value *of* financial capital. (p. 342)

In his empirical work, Seccareccia describes banks' rates of return on quantitative easing (QE) purchases of government bonds and mortgage-backed securities (and other variables, including GDP growth and interest rate spread).

Epstein and Montecino (2020) investigate three phases of quantitative easing in the US during the 2010s. In the first phase (QE1), 'large financial firms were expected to benefit from QE1, as were several other key business sectors, including energy, construction, and autos' (p. 196). During QE2, 'the mean expected benefits for all firms were reduced somewhat relative to those expected in QE1' (p. 196). During QE3, the mean expected benefit was very small.

These examples demonstrate the policy measures adopted by central banks that served financial interests.

6. Central Bank 'Independence' and the Climate Emergency

Economic and social events over the past decade have posed questions for the future nature and objectives of monetary policy and the central bank. These events include the global financial crises, the COVID-19 pandemic, increasing concerns regarding inequality, and, most significantly, the climate emergency. The policy mandates of central banks have begun to shift towards financial stability and paying attention to issues of inequality and the climate emergency.

Central banks have a role to play in support of strategies to address the climate emergency and the transition to a low carbon economy. Campiglio et al. (2018, p. 463) indicate four types of interventions that central banks (and financial regulators) could adopt

to help deal with climate-related risks. The first is development of 'methodologies and tools that would promote a better understanding of these risks and their economic and financial implications'. Second, 'investors can be encouraged or required to disclose their exposure to climate-related risks'. Third, 'these risks can be explicitly taken into account in setting financial regulations'. Fourth, 'central banks can take into account climate-related risks in their policy toolkit (for example, through monetary policy)'.

A highly significant question arises here regarding who should be responsible for establishing which investments and activities are to be considered 'green' and which 'dirty'. The responsibility for creating environmentally-friendly policies lays firmly with the government, and the central bank (and other institutions) should make policy decisions that support the policies of the government.

Two categories of climate-related risk — physical risks and transition risks — are identified, which have consequences for the financial sector and its stability, and thereby implications for the central bank and its policy operations. Physical risks cover, for example, gradual global warming and its associated physical changes, natural disasters such as hurricanes, floods and heatwaves, and lasting environmental damage. Transition risks are posed by the policy and technological changes necessary to achieve a greener economy. As the ECB argues, 'climate change affects macroeconomic outcomes, financial markets and institutions primarily through two channels: physical risk and transition risk' (ECB 2021, p. 6). Further,

> climate change is a systemic risk to the financial sector … . In the financial system, systemic risks are risks that have the potential to destabilize the normal functioning of the system and lead to serious negative consequences for the real economy. (Gelzinis and Steele 2019)

The policies of central banks should be supportive of and consistent with government policies on environmental sustainability and climate change. Addressing climate change requires co-ordination between central bank and government and, thus, at least in this situation, an end to central bank independence. This co-ordination should include the financing and funding of government expenditure by the central bank and use of common taxonomy to describe environmentally-friendly investments and activities. The central bank purchase of financial assets under schemes such as QE should involve acceptance of 'green' financial assets only in a departure from 'market neutrality'. Green financial assets are thereby favoured over 'dirty' financial assets. Structural changes in the economy can make IT more complex (even though doubts exist regarding the effectiveness of interest rate variations on control of inflation). Financial stability, a key concern for many central banks, may be threatened by 'stranded assets', with the possibility of sharp price adjustments and threats to loan repayments. Financial stability policies may be designed to alleviate the possible impacts of instability rather than to address the underlying causes of such instability. Systemic risks resulting from the climate emergency cannot, however, be effectively addressed through monetary policy and financial regulation.

7. The Central Bank and Inequality

Income and wealth inequality have grown in most industrialized countries in the past three to four decades. Mark Carney (2016, p. 10), former governor of the Bank

England, remarked that 'all monetary policy has distributional effects', though the significant questions to address are the nature and scale of those distributional effects and how far the operations of a central bank should seek to influence income distribution or take distributional effects into account when setting monetary policy. Indeed, Carney completes that sentence by saying that 'it is rightly the role of elected governments to take measures to offset them [the distributional effects] if they so choose'.

Bernanke (2015) views 'inequality and lack of social mobility [as] issues of first order significance for economic policy in general' but expresses doubts regarding whether they should be 'first-order considerations for the making of monetary policy'. He views

> the degree of inequality we see today [as] primarily the result of deep structural changes in our economy that have taken place over many years, including globalization, technological progress, demographic trends, and institutional change in the labor market and elsewhere,

though the roles of the financial sector and financialization are not mentioned.[4] Bernanke then argues that the effects of monetary policy on inequality are 'almost certainly modest and transient', compared with those of structural factors, and thus conforms to the mainstream view that monetary policy is 'neutral'.

Bunn, Pugh, and Yeates (2018) report that the overall effect of monetary policy on relative measures of income and wealth inequality in the UK during the period 2008–14 was small during a time when income and wealth inequality were broadly stable. They estimated that those of retirement age gained most from monetary policies protecting wealth, but that support to incomes disproportionately benefitted the young. Ampudia et al. (2018) found that low short-term interest rates hurt households owning non-negligible amounts of liquid assets ('savers') through the reduction in their income resulting from those assets. But they also reported that there is an indirect effect whereby low interest rates lead to a lower unemployment rate and higher labour income. This indirect effect dominates in quantitative terms. They also found that, for the four largest euro economies, the asset purchase programme reduced income inequality, largely through a reduction in the unemployment rate offered to poorer households, though the effects of monetary policy on income inequality are modest as compared to those resulting from secular trends. Domanski, Scatigna, and Zabai (2016) find that, 'while low interest rates and rising bond prices have had a negligible impact on wealth inequality, rising equity prices have been a key driver of inequality. A recovery in house prices has only partly offset this effect' (p. 45).

Samarina and Nguyen (2019) examined how monetary policy affected income inequality in ten euro area countries during the period 1999–2014. They found that expansionary monetary policy in the euro area reduced income inequality, especially in the periphery countries. Macroeconomic channels exist through which monetary policy has an effect, with monetary easing found to reduce income inequality by raising wages and employment. There are some indications that a financial channel through which monetary policy impacts on asset prices and returns may weaken the equalizing effect of expansionary monetary policy.

Colciago, Samarina, and de Haan (2019), in their survey on monetary policy and inequality, argue that most empirical studies have analyzed each possible channel of

[4]See Sawyer (2019) for a review of financialization and inequality.

redistribution in isolation. Their 'review suggests that empirical research on the effects of conventional monetary policy [interest rate] on income and wealth inequality yields mixed findings' (p. 1199). They also report that 'conclusions concerning the impact of unconventional monetary policies [e.g., quantitative easing] on inequality are also not clear cut' (p. 1199).

'[T]he policy [of QE] has also had the effect of inflating asset prices *artificially*, and this has benefited those who own them disproportionately, exacerbating wealth inequalities' (House of Lords 2021, p. 5, emphasis added). Domanski, Scatigna, and Zabai (2016) found that 'low interest rates and rising bond prices have had a negligible impact on wealth inequality, rising equity prices have been a key driver of inequality … [and] monetary policy may have added to inequality to the extent that it has boosted equity prices' (p. 45).

Central bankers almost uniformly recognize that the distributive effects of unconventional monetary policy are not minor. The main mechanism identified is that the high level of asset purchases pushes up the price of assets, which are disproportionally held by the wealthiest households (Bank of England 2012). Carney (2014) said that, 'the distributional consequences of the response to the financial crisis have been significant' (p. 4). However, central bankers continued to argue that these effects are unintended and temporary. Authors at the ECB (e.g. Altavilla et al. 2021) explore the side effects of unconventional monetary policy viewed as unintended consequences, and Haldane (2014), from the Bank of England, stresses that unconventional monetary policy 'was taken with the best of intentions' (p.4) and lead to a range of side effects; thus, all these central banks share the idea that the effects are temporary and unintended.

These findings generally point to relatively small effects of monetary policy on inequality. Further, any effects may be largely reversible. A reduction in interest rates may have a particular, if small, effect on income inequality; but an increase in interest rates may well have the opposite effect. It is, of course, possible that the effects are not symmetrical and path dependence effects exist.

It can be agreed 'that there is enough evidence to conclude with confidence that monetary policy does affect inequality. The magnitude and the duration of the impact must be better studied' (Kappes 2023, p. 227). In the context of 'independence' and IT, central banks appear to be precluded from taking into account the impacts of their policies to address inequality. It is, however, a case whereby some co-ordination between central bank and government is called for to enable government to consider policies such as a wealth tax, which could address some of the inequality effects of monetary policy. Used as a policy instrument, the interest rate does have an impact on the distribution of income between borrowers and lenders. In that context, it is useful to determine the central rate around which the actual policy rate varies and whether or not variations in the interest rate are used to influence the level of demand (and, under IT, thereby the rate of inflation). Arestis and Sawyer (2010) argued for a real rate of interest in line with the rate of growth of productivity, with the nominal rate of interest adjusted on an annual basis (say). This idea of a policy interest rate around the rate of growth of productivity has a number of interesting implications. It can be considered as a 'fair rate' of interest (Pasinetti 1981), which 'in real terms should be equal to the rate of increase in the productivity of the total amount of labor that is required, directly or indirectly, to produce consumption goods and to increase productive capacity' (Lavoie and Seccareccia 1999, p. 544).

Rochon and Setterfield (2007) contrast two approaches to interest rate policy, which they label the 'activitist' and the 'parking-it' rules. The activist approach has the general feature of using interest rates as a tool for aggregate demand fine-tuning, of which the Taylor rule is one example. The parking-it rule includes setting the interest rate at a pre-determined level: examples are the zero nominal rate rule, the Smithin zero real rate rule, and the fair rate rule; in the latter two cases, the nominal rate set would adjust in line with inflation. The particularly significant element here is that the policy interest rate would be set in terms of a constant rate and as government policy; it would be advocated for on the basis of reasons associated with income distribution (in the case of Smithin, euthanasia of the rentier).

Setting the policy interest rate on this basis is not without its difficulties — estimation of the trend growth rate and misalignment of the domestic interest rate with international rates are examples. The interest rate is set in nominal terms and hence must be based on the 'fair rate' plus (expected) inflation. How far the aim should be to make the real rate of interest constant, broadly speaking, or whether the interest rate should also respond to current conditions, e.g., being much lower in times of low demand, remain to be discussed.

The setting of a 'fair' rate of interest is based on distributional considerations; specifically, that it would preserve the relative purchasing power of savings. It can, of course, be argued that these are not specific approaches to follow, and others could be applied.

8. Concluding Comments

The independence of central banks can be viewed as a 'zombie idea'; that is, an idea that will not die, no matter how often it is disproved. Noting the difficulties associated with an idea is tantamount to stating that it has failed, unequivocally. It is necessary to

> recognize that some of the policy ideas may have had some positive effect at some points in time, and in some places. However, we argue that these ideas have become so ingrained in the policy making systems that they may be adopted without adequate thought, even when they are not useful or may be counterproductive. (Peter and Nagel 2020, p. 7)

We consider the independence of central banks to be a zombie idea for three reasons. First, in its IT guise, it draws on an intellectual framework (summarized as the new consensus in macroeconomics), which is highly deficient as a representation of the economy (as argued above). Second, the generally lower rates of inflation in the industrialized countries over the past two to three decades cannot be attributed to the adoption of IT, as the evidence summarized above indicates. Further, IT is incapable of responding to supply disruption and cost-push inflation, as was very well illustrated during the pandemic. Third, the independence of central banks limits, if not precludes, co-ordination of central bank decisions and policy measures with government decisions and policy measures. The IT framework supports a one-instrument (interest rate), one-policy objective (target rate of inflation). Macroeconomic policies have many instruments at their disposal and many objectives. The conduct of monetary policy has consequences for variables that can serve as policy objectives, including financial stability, climate change and inequality. It is necessary to ensure that policies enacted by the central bank pay

due regard to financial stability, climate change and inequality, though other government policies have much greater effects.

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