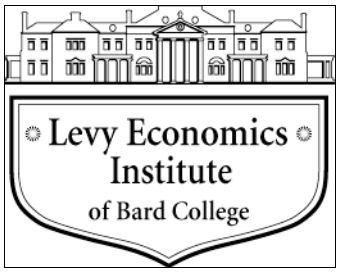

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A Post Keynesian Perspective on the Rise of Central Bank Independence: A Dubious Success Story in Monetary Economics

by

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ABSTRACT

This paper critically assesses the rise of central bank independence (CBI) as an apparent success story in modern monetary economics. As to the observed rise in CBI since the late 1980s, we single out the role of peculiar German traditions in spreading CBI across continental Europe, while its global spread may be largely attributable to the rise of neoliberalism. As to the empirical evidence alleged to support CBI, we are struck by the nonexistence of any compelling evidence for such a case. The theoretical support for CBI ostensibly provided by modeling exercises on the so-called time-inconsistency problem in monetary policy is found equally wanting. Ironically, New Classical modelers promoting the idea of maximum CBI unwittingly reinstalled a (New Classical) "benevolent dictator" fiction in disguise. Post Keynesian critiques of CBI focus on the money neutrality postulate as well as potential conflicts between CBI and fundamental democratic values. John Maynard Keynes's own contributions on the issue of CBI are found worth revisiting.

Keywords: Central Banks; Central Bank Independence; Democratic Accountability; Monetary Policy; Time-inconsistency

JEL Classifications: B31, B59, E02, E50, E61

1. INTRODUCTION

The notion of central bank independence (CBI) refers to the relation between the central bank and the state, the legislature, and executive. In practice, central banks typically engage in a wide range of activities related to the currency sphere and the financial system. Their relations with the political authorities may be correspondingly wide-ranging too. In this regard, the mainstream literature popularizing CBI features a "narrow central bank" approach that concentrates on their monetary policy functions only, ignoring important interdependencies between monetary policy on the one hand, and central banks' historical role as government's banker (as one link to fiscal policy) and their role in safeguarding the financial system's stability on the other.

Regarding the monetary policy domain in central banking, it is important to keep the issue of monetary structure conceptually separate from policy conduct. The notion of CBI pertains to the structure of monetary policy, which concerns the regulation of central banks in general and their relation to the state in monetary policy matters in particular. Policy conduct concerns the appropriate goals of, and ways to implement, monetary policy in the context of the country's general economic policy. While monetary structure and conduct are conceptually separate, from an economic perspective the issue is that monetary structure may positively or negatively affect the quality of policy conduct as measured by its contribution to economic performance and welfare. In fact, if institutions matter at all, the issue of establishing central bank regulations and incentive structures that encourage sound performance of policymakers can hardly be denied. In addition, from a political perspective, the issue is that monetary structure should presumably comply with general democratic principles. The ultimate quest, then, is to design a monetary structure that is both efficiency-enhancing and democratic.

What does it take for a central bank to be "independent"? The general connotation of "independence" is that of some sort of state of freedom from political interference with monetary policy. Monetary policy, proponents of the idea suggest, could and should simply be taken out of political control and turned over to "independent" central bank control. A very broad definition of CBI would then seem to require that the central bank is institutionally separate from other government institutions and enjoys some degree of legal and/or actual protection from direct political interference in its areas of monetary policy responsibility. Popular measures of CBI produce "CBI scores" and rankings of various central banks. These scores typically include

indicators for: security of central bankers' tenure (or turnover rates) and appointment processes, whether the government can participate in policy deliberations or even overturn policy decisions, how clearly policy goals may be defined and whether the government has any say in specifying them, whether the central bank has authority over its own budget and finances, and whether lending limits to the government may be in place. The general presumption in these kinds of exercises is that the more independent (empirically, the higher the CBI score), the better. The economic benefits are then simply taken for granted. The literature is also remarkably aloof as to the issue that taking monetary policy "out of political control" might impinge on democratic values.

The aim of this paper is to critically assess the rise in CBI as an apparent success story in modern monetary economics. As to the observed rise in CBI since the late 1980s we single out the role of peculiar German traditions in spreading CBI across continental Europe while its global spreading may be largely attributable to the rise of neo-liberalism. As to the empirical evidence supposedly supporting CBI, we are struck by the nonexistence of any compelling evidence for such a case. The theoretical support for CBI as supposedly provided by modeling exercises on the so-called time-inconsistency problem in monetary policy is found equally wanting. In fact, we have to attest that New Classical modelers promoting the idea of maximum CBI made heroic fools of themselves by unwittingly reinstalling a (New Classical!) benevolent dictator fiction in disguise in the process. Perhaps the theoretical shallowness and practical irrelevance of the mainstream CBI literature explains why Post Keynesian contributions on the issue of CBI are rather less plentiful. The concept of money neutrality is found to be central to Post Keynesian criticisms of CBI. In addition, there is greater awareness that CBI may conflict with fundamental democratic values. While we broadly share these concerns, an important message of this paper is that outright rejection of CBI may not be warranted either. Keynes's own contributions on the issue of CBI are found worth revisiting.

2. WORLDWIDE RISE IN CBI

Twenty-five years ago only three central banks in the world were considered independent from or within their respective government, namely: the Federal Reserve System of the United States, the German Bundesbank, and the Swiss National Bank (Lastra 1996). Since the late 1980s

numerous countries have implemented reforms that granted central banks greater independence from direct political influence.

The rise in CBI is partly due to the advent of Economic and Monetary Union (EMU) in Europe. As Germany made clear in the run-up to the Maastricht Treaty on European Union (EU) in the early 1990s, CBI would be *sine qua non* for the aspired EMU to be launched before the end of the decade. Both the supranational European Central Bank (ECB), which was newly to be founded, as well as the national central banks to become part of the European System of Central Banks (ESCB)—formed to take on the guardianship of the euro as Europe's "single currency"—had to strictly conform to the status of independence previously only enjoyed by the Bundesbank among EU member countries.[1] Certainly within continental Europe the peculiar German tradition of CBI was the foremost cause for its spreading.

But the rise is CBI has spanned both developed and developing countries around the globe. The global trend started with New Zealand and Chile in 1989. By the mid-1990s, the group of countries that had implemented central bank reforms also included: Argentina, Australia, Canada, Colombia, Ecuador, Egypt, El Salvador, Hungary, Mexico, Peru, Philippines, South Africa, Turkey, Uganda, Venezuela, and Vietnam, for instance. In 1998 the prominent cases of the Bank of England and Bank of Japan joined the expanding group of newly independent central banks. The trend continued (see Daunfeldt and de Luna [2008] and Daunfeldt, Hellström, and Landström [2008]). Rather interestingly, Crowe and Meade (2007) find that by the mid-2000s the Federal Reserve's CBI score, which has remained stable over time for lack of any amendments to the Federal Reserve's statutes and which had given the Federal Reserve a top global ranking in 1980, has meanwhile been slipping in global rankings significantly below the mean for advanced economies.

The worldwide ascent in CBI coincided with a rising prioritization of price stability among monetary policy objectives and rising popularity of "inflation targeting" among central banks (a policy strategy based upon the "new consensus macroeconomics"; see Arestis and Sawyer [2003]). Furthermore, the era saw a significant number of influential academic monetary economists and proponents of inflation targeting crossing trade lines to become either central

[1] Although not mentioned in the original Maastricht Treaty, the actual guardianship of the euro today rests with the "Eurosystem" rather than the ESCB, including only the national central banks of those countries that have adopted the euro as their common currency. The influence of the Maastricht Treaty in matters of CBI went far beyond the EU of 12 member states at the time, from shaping developments early on in the sphere of today's 27 member states and other neighboring European countries.

bank economists or policymakers. Discussing "how the world achieved consensus on monetary policy," Marvin Goodfriend (2007: 65) observes that "today, academics, central bank economists, and policymakers around the world work together on monetary policy as never before." The cross-fertilization among theorists and practitioners of monetary policy supposedly contributed to the "great moderation" of simultaneous declines in output volatility and inflation to low levels. Following a period of "practical and theoretical disarray in the 1970s" (Goodfriend 2007: 48) this was even more remarkable—a great success story in modern monetary economics, it would seem.

Proponents of CBI are keen to peddle the idea that the modern case for CBI is based on strong empirical evidence. In an influential paper presenting a statistically significant association between greater independence and lower inflation for advanced countries, Alesina and Summers (1993) also related CBI to economic performance more broadly, suggesting that CBI would offer lower inflation at no real costs (see also Grilli, Masciandaro, Tabellini [1991] and Eijffinger and Schalling [1993]). The absence of any correlation between CBI and real economic performance is actually a rather troubling finding, given that price stability as the primary or even sole goal for monetary policy is generally justified on the grounds that low inflation would somehow improve real economic performance. Promoting CBI as a free lunch then assumes that reducing inflation is of benefit in itself, regardless of any actual improvement in real performance.[2]

Even the evidence for CBI as a guarantor of low inflation as such is far less compelling than it might seem at first (Goodhart 1994; Forder 1998a and 2000). Numerous deficiencies afflicting the empirical evidence supposedly supporting CBI have been pointed out. For instance, Carvalho (1995–96) and Forder (1996 and 1999) fundamentally challenge the evidence for its circularity in approach. By first identifying elements that show a negative correlation with inflation and then running regressions on a CBI index that includes these very elements, no meaningful hypothesis testing is possible. Forder (1996 and 1999) also highlights that the common statutes-reading approach to measuring CBI fails to provide any real test of a hypothesis that focuses on the actual behavior of central banks. That different studies generally show only limited harmony is another critical issue. True, the German Bundesbank is commonly found at the top of the list and, in view of Germany's much-envied inflation record, one may

[2] As to the short term, there is the puzzling finding of a positive correlation between CBI and the "sacrifice ratio" measuring the output costs of deliberate disinflation policies. See Ball (1997) and Jordan (1998).

perhaps close the file, if one really wanted to. That different CBI measures yield rather different rankings for central banks below the top position certainly alerts more critical observers as to robustness of (Forder 1999), and/or the "tale of subjectivity" involved in, the "evidence" supposedly supporting the case (Magano 1998). Needless to say, simple correlation does not prove that causality runs from CBI to lower inflation. Reverse causality or the presence of unidentified third factors are bothersome possibilities. While some researchers (for instance, Cornwall and Cornwall [1998] and Fuhrer [1997]) worry that the correlation may be spurious, others suggest that CBI and inflation may be endogenous (for instance, Campillo and Miron [1997], Hayo [1998], Posen [1993], and Hayo and Hefeker [2002]). Rather tellingly, a recent update of the evidence by Crowe and Meade (2007) could not even confirm the supposed inverse relationship between CBI and inflation for industrial countries.

Among these criticisms, Posen's (1993) argument about financial sector interests providing important backing for price stability and, indirectly, CBI seems of particular interest.[3] Financial sector interests may matter in more than one way. Historically, central banks used to play the lead role in safeguarding financial stability, as lenders of last resort and through measures aimed at preventing financial instability in the first place. As the advent of modern monetary policy after WWII generally brought greater political control over central banks, this also affected the relationship between the central bank and financial institutions, given that the domains of monetary policy and financial stability policy are closely intertwined.

Yet financial players may also favor CBI as a way of keeping the political authorities at arm's length and especially so with regard to financial stability policy (which involves oversight over their actual business rather than macro-relevant outcomes). Since the 1980s, financial liberalization has shifted the balance of power between the markets and the state in favor of the former. From the viewpoint of the political authorities this also raises the specter of excessive concentration of power within the independent central bank. The Bank of England reform of the late 1990s provides an interesting case featuring increased operational independence in matters of monetary policy together with the simultaneous establishment of a new public authority for financial oversight purposes.[4]

[3] Heterodox contributions emphasizing interest groups and class struggle include Arestis and Sawyer (1997) and Epstein (1994).

[4] This arrangement was to become a victim of the global crisis a decade later, when a new conservative-liberal coalition government granted the Bank of England greater authority in the area of financial stability.

Perhaps a more cautious interpretation of the evidence would highlight that the popularity of CBI[5] arose in an era when global inflationary pressures were subdued and inflation rates were declining globally, quite irrespective of reforms to central bank governance and pursuit of inflation targeting strategies. Neo-liberalism and the "Washington Consensus" describe the predominant ideological currents of the time. Beliefs in the efficiency of the invisible hand of liberalized and self-regulated markets were running high. As global financial integration progressed markedly, global capital flows and cross-border holdings of financial instruments, including innovative derivatives, soared to ever-new record levels. With unfettered market rule spreading, government control was generally seen in retreat. Against this general climate, or "Zeitgeist," there were even prominent cases of incoming left-wing governments that granted their central banks greater independence (New Zealand, UK, for instance; see Goodhart 2002).

Regarding the key influence of Germany in the European context, it must be stressed that global ideological fads were largely irrelevant in spreading CBI across the continent. Germany's penchant for CBI long predates the modern global move towards CBI. The German CBI tradition derived from very peculiar historical circumstances. In popular belief, the occurrence of two hyperinflations within one generation caused Germany's legendary inflation hypersensitivity and support for CBI. It turns out though that this is largely a myth nourished by central bankers to attain and maintain their independence—which itself may be a highly relevant fact in assessing CBI.

Germany did experience *one* proper hyperinflation, in 1922–23, which was followed by the Great Depression less than a decade later. The Great Depression experience is still haunting U.S. policymakers today. While similarly severe in Germany, the Great Depression episode has since been deleted from collective memory. The irony is that the German Reichsbank was independent at the time of Germany's hyperinflation in the 1920s and the Great Depression of the early 1930s, until Hitler took over, riding on agonies caused by the bank, among other things. The economic consequences of Adolf Hitler then appear as the second hyperinflation (ending with the currency reform of 1948) in that disgraceful rewriting of German history that is so

[5] See Forder's (2005) overview and perceptive discussion of the puzzling rise in approval of CBI.

popular with German central bankers.[6] As much else, the Nazis also ended Germany's pre-WWII record of CBI—which may be judged exceptionally poor (Giersch and Lehment 1981).

In the early post-WWII years, sobering experiences with the independence of the Reichsbank provided the key argument *against* CBI for German industry and for the leader of German ordoliberalism, Walter Eucken, too. Rather than originating from hyperinflation sensitivities, the peculiar German tradition of CBI that was going to conquer continental Europe 50 years later arose as a historical accident.

(West) Germany's postwar CBI tradition has a peculiar historical background that begins with a law imposed by the victorious (Western) Allies in charge of the defeated nation sliced into occupation zones in 1945. The Allied law stated that the newly established central bank would not be subject to instructions from German political authorities. The apparent imposition of CBI occurred neither out of conviction for the cause nor in replication of the Allies' situation at home, which, in all three cases, did not feature CBI. Instead, it was for the simple reason that the Allied occupation forces wanted to secure their own full control over the bank while holding German influence at bay. Importantly, at the time when the new "Bank deutscher Laender" (BdL) was established on March 1, 1948, as the cockpit of the central banking system that also included the "Landeszentralbanken" (LZBs) established in 1947–48 in replication of the decentralized structure of the U.S. Federal Reserve System, no federal German government, in fact no German state, existed yet. As a result, Germany's central bankers enjoyed a political head-start and wonderful opportunity for reputation building in a demoralized war-worn society. When West Germany was then founded in 1949 and the first federal government led by Konrad Adenauer emerged on the scene after the election in August of that year, this also followed the currency reform of June 20, 1948 that had introduced the deutschmark and central bankers as guardians of stability had already left a mark on the public spirit towards the new currency.

The situation for the BdL started to change in the fall of 1949 when the allied authority controlling the central bank prepared for withdrawal of its oversight. Simply withdrawing would have left a corresponding vacuum of political control, so the Allies pressed the young German

[6] For instance, former Bundesbank president Hans Tietmeyer (1991: 182) declared: "The reasons for the success of German monetary policy in defending price stability are in part historical. The experience gained twice with hyperinflation in the first half of this century has helped to develop a special sensitivity to inflation and has caused the wider public to believe in the critical importance of monetary stability in Germany. For this reason, the strong position of the Bundesbank is widely accepted by the general public—questioning its independence even seems to be a national taboo. This social consensus has yielded strong support for the policy of the Bundesbank."

government to establish a substitute arrangement before it thought it could do so. A drawn-out negotiation process between the bank and the government started that saw central bankers fighting for their "continued" independence. This was met by resistance from Chancellor Adenauer, who was keen to obtain ultimate control over the bank and considered anything else unconstitutional. Under pressure from the Allies to settle the matter, an interim law ("Übergangsgesetz") was finally agreed.

As it turned out, the interim law that came into effect on August 10, 1951 prejudiced the final law—the Bundesbank law of 1957, taking up another six years of negotiations—in all its essentials. "The law of 1951 properly established the German tradition of CBI, featuring a vaguely defined remit for the bank together with its obligation to support the government's general economic policy; albeit leaving it at the bank's discretion to determine the point at which it might more or less openly oppose the government" (Bibow 2009a). In fact, public confrontations between the bank and the government became a recurrent theme in West Germany's history. In theory, the Bundesbank law was a simple law that could have been changed at any time to give the government greater control over the bank. It never happened. From early on the Bundesbank—following the footsteps of its BdL forerunner—skillfully handled its public relations machinery to secure a strong backing in public opinion. Orchestrated public confrontations served this end, presenting the bank as the ultimate guardian of stability against rogue attacks by irresponsible politicians.

While Posen stresses financial sector interests, which also seem to have played a role in the German context, industrial interests also became favorable to CBI, overcoming their original opposition. This arose as (West) Germany's infamous export orientation became established in the context of fixed nominal exchange rate regimes (first under Bretton Woods and later under the European Monetary System). Keeping German inflation below trading partners' inflation, while resisting revaluation as long as possible, provided an important competitive edge to German industry. The Bundesbank's part was to discipline both the unions and fiscal policy. As long as exports provided sufficient stimulus to GDP growth, the outcome actually worked for all parties concerned, with price stability *causing* (export-led) growth under these peculiar circumstances.

The importance of this historical episode, featuring the emergence of the peculiar German CBI tradition as a historical accident (and the growth-friendly character of the low

inflation record it became associated with), can hardly be overemphasized. Arguably, it provided the one and only truly relevant factor in spreading CBI across continental Europe in the 1990s through the Maastricht Treaty.[7] We will return to the German model of CBI below to compare it with Keynes' CBI model. The next section scrutinizes some modern theoretical developments that, at least in the eyes of many mainstream economists, provided important impetus to the global spreading of CBI—outside of continental Europe, that is.

3. THE TIME-INCONSISTENCY CASE FOR CBI: A NEW CLASSICAL FICTION

The CBI idea became rather fashionable with mainstream economists in the 1990s. The theoretical foundations supposedly supporting the case for CBI were developed within New Classical modeling traditions and will be critically reviewed in this section. In view of certain ideological presuppositions of monetarism and New Classical thought, it is important to emphasize upfront that in matters of CBI, developments involved a striking break with earlier monetarist ideas. Milton Friedman, the arch-liberal who initiated the monetarist counterrevolution, categorically rejected central bank independence.

In his article, "Should There Be an Independent Monetary Authority?," Friedman (1962: 178) finds that central bank independence "embodies the very appealing idea that it is essential to prevent monetary policy from being a day-to-day plaything at the mercy of every whim of the current political authorities," but then concentrates on what he perceives to be the flip-side of the matter. Politically, he rejects the concentration of vast powers "in a body free from any kind of direct, effective political control" (Friedman 1962: 188). Economically, his key concerns are, first, the dispersal of responsibilities for monetary and fiscal policies and the lack of overall accountability this would involve; second, that the rule of men rather than law makes policy extraordinarily dependent upon *personalities*, risking "accidents of personality"; and third, that independent central bankers might be too susceptible to particular influences and interests (of bankers, in particular). Regarding the objection to eliminating the Fed's independence (that this would make monetary policy a plaything of politics), Friedman remarks that his "own

[7] As this fact may be politically rather unappealing the European Commission issued a study meant to provide the economic case for CBI along the lines of the mainstream arguments criticized in section 3—a study that was scrutinized (and demolished) by Forder (1998b).

examination of monetary history indicates that this judgement is correct, but that it is an argument for, not against, eliminating the central bank's independence" (Friedman 1984: 44).[8]

Given that monetary policy can have disastrous real effects in "the short run" (which he thought of as a decade),[9] Friedman was highly troubled by the idea of a central bank with discretion, but outside of political control. In Friedman's view, rather than merely "insulating" money from politicians, "neutralizing" the (unelected) central bank politicians through a monetary rule is a superior arrangement since:

> An independent Fed may at times be too insulated from political pressures—as it was in the early 1930s—and yet at other times unduly affected by political pressures. ... A monetary rule would insulate monetary policy both from the arbitrary power of a small group of men not subject to control by the electorate and from the short-run pressures of partisan politics (Friedman 1972: 227).

Later New Classicals side with Friedman on the issue of rules rather than discretion—or so it may seem at first. Strangely, however, the problem of time inconsistency allegedly arising in "discretionary" monetary arrangements came to be seen as supporting CBI, turning Friedman's argument upside down. A closer look reveals that the notions of rules and discretion attained new meanings in New Classical contributions. And it turns out that CBI became seen as representing "rule," when it was still a synonym for discretion to Friedman. Most importantly, Friedman's emphasis on "long and variable lags" in monetary policy got lost altogether in the New Classical reincarnation of the case for rules rather than discretion, alleging that an inflationary bias emerges in equilibrium whenever the structure of monetary policy features "discretion."

The new theory of inflation is recast in a Lucas-type natural rate world of money neutrality, rational expectations, and policy ineffectiveness. In such a world, any *systematic* monetary policy fails to have real effects. With a Lucas-type supply function held to describe the relation between output and inflation, only *surprises* are effective. There are two players in the game, a policymaker and a representative *labor*-market participant (the public), playing a one-shot game. The timing protocol says that wage contracts are stipulated *before* the policymaker

[8] Ahamed (2009) offers a lucid account of the personalities of the (all too) independent central bankers that pulled the strings in international monetary affairs at Keynes's time, featuring Keynes as "a useful counterpoint" to the "Lords of Finance" (and their "accidents of personality") in his historical account.

[9] After all, Friedman's (1963; with Anna Schwartz) influential account of the Great Depression has the Federal Reserve as the main villain in the play.

decides about the instrument setting. And, importantly, policymakers are envisioned to be equipped with an "inflation surprise" instrument. In this New Classical world, central banks do not set interest rates, but simply flip their inflation surprise switch. In choosing inflation in this miraculous way, the policymaker is envisioned to minimize a loss-function that typically features two arguments, namely, deviations from inflation and unemployment (or, output) target values.

The policymaker is benevolent and, sharing identical preferences with the public, dislikes inflation. The trouble is that this natural-rate world in this game setup is not quite perfect. Due to some "distortions," the Phillips curve is vertical at "too high" a natural rate. As a result, the policymaker feels a peculiar temptation to achieve a level of unemployment *below* the—unnaturally high—natural rate. Within this model setup, the overambitious employment target underlying the postulated goal conflict is, in principle, attainable by riding up a short-run Phillips curve. In control of an inflation surprise switch, the policymakers give in to the temptation and attempt to quickly ride up a short-run Phillips curve.

The problem is that the benevolent policymaker is facing a labor market player who is clever enough to fully understand the game that is being played. The other player discerns that the optimal zero inflation policy will be time-inconsistent (i.e. no longer optimal after wage contracts are settled). Within the chosen model setup, the other player has reason to rationally expect the policymaker, if equipped with discretion, to renege on the optimal zero-inflation policy and to spring deliberate "inflation surprises" upon them. In equilibrium, there will be positive inflation, but no inflation surprise and no riding up any short-run Phillips curve. The system is inevitably stuck at its (distorted) natural rate level of unemployment, but a suboptimal inflation bias allegedly arises nevertheless.

At least this appears to be the inevitable outcome if the policymaker has the *potential* to surprise at hand, quickly translated as representing "discretion." By contrast, if the policymaker foregoes the *option to reoptimize* by precommiting to a "rule," the system, while still ending up at the (distorted) natural rate level, would not suffer the extra burden of an inflationary bias. This is the time-inconsistency case for "rules rather than discretion."

Note here that if the option to reoptimize were the true problem, then only a simple rule, easy to implement and observe but difficult to change, would do. At least this is what Kydland and Prescott (1977) saw as the upshot of their contribution. In their view, optimal feedback rules would give rise to the time-inconsistency problem. When Barro and Gordon (1983a) applied the

time-inconsistency idea more specifically to monetary policy, they concentrated on the perceived problem that a binding precommitment to any "rule," in the sense of a "once-and-for-all choice" may be difficult to arrange in practice. In their view, the policymaker would always face the incentive to renege on the rule, if that were possible. This concern added a new "credibility" dimension to the issue.

Rogoff (1985) then reintroduced a proper rationale and possibility for *effective* stabilization policies by postulating that shocks occurred after wage contracts are stipulated, but before the policymaker sets inflation. In stochastic versions of the above game, feedback rules *are* of real benefit as discretion is, once again, effective in offsetting shocks hitting the system. Accordingly, a lack of *flexibility* to respond to shocks is seen as giving rise to a "stabilization bias." A trade-off between (credible) commitment and flexibility thus emerges. In rediscovering the benefits of flexibility and the Keynesian quest for deliberate stabilization of an unstable economy, strangely, the notion of "rule" got all the credit.

Do not miss that the internal logic of the setup displays the following paradox. On the one hand, one is asked to imagine a policymaker who is benevolent, competent, and omniscient, as well as a perfect image of society's values. On the other hand, this sad creature seems incapable of accepting the natural inevitable (i.e., the natural rate). The time-inconsistency story assumes the utmost degree of rationality of both the government and the public, but then has the government trying to achieve the impossible through the formulation of the loss function. Why should anyone rationally aim at maximizing an objective function that focuses on the impossible? In effect, the time-inconsistency literature cartoons discretion as a fully transparent lunatic crusade.

McCallum (1995 and 1997) seems to recognize this tension concerning the policymaker's presumed behavior, but he fails to properly address the bias of irrationality. Instead, he implies that all the policymaker must do is simply to recognize the futility of seeking to exploit a nonexistent trade-off and refrain from doing so. He bluntly asserts that "an unconstrained but independent" central bank could simply ignore existing expectations and pursue a zero-inflation policy. As the alleged time-inconsistency problem could hardly be assumed away more elegantly, we get the true flavor here of the New Classical fashion for CBI. By definition, an "independent" policymaker would use discretion wisely and deliver the rule outcome in this obscure game—a New Classical benevolent dictator fiction in disguise!

The theoretical literature features mainly three lines of arguments for CBI as a solution to the alleged time-inconsistency problem. First, the issue of time horizon: independence is presented as a device for insulating monetary policy from *myopic* political pressures. Periodic democratic elections imply a time horizon for policymaking that is *variable* and possibly fairly *short* on critical occasions. As the same may hold when the independent central banker's contract is up for renewal, the best chances for a far-sighted policymaking approach, and least dependence on particular individuals and the peculiar influences they are exposed to, might seem to occur if an *esprit de corps* developed, the central bank's *infinite* life-span becoming the policymaking horizon. An independent central bank with an *esprit de corps* may be best-positioned to play the *credibility by reputation building* game as set in multi-period extensions with infinite horizon of the basic one-shot time-inconsistency game (Barro and Gordon 1983b).

Second, concerning the issue of degree of inflation aversion, independence may be seen as a device to install an anti-inflationary personality bias in policymaking that might compensate the inflationary bias held to arise from the alleged time-inconsistency problem. Rogoff (1985) suggested that appointing an independent central banker who does *not* share society's preferences, but places a relatively higher loss on inflation deviations (such socially abnormal predilections being dubbed "conservative") would promise such benefits.

Third, through establishing accountability for (mal-)performance: independence may be seen as a device that establishes proper incentives for sound policymaking through a punishment threat. For instance, Walsh (1995) champions the idea of designing an optimal incentive scheme for an independent monetary agent held to account for performance by a state principal.

Unsurprisingly, the arguments for CBI are equally as shallow as the New Classical time-inconsistency fiction they are derived from. Svensson (1997: 100) surely misses the point when he downplays the vital role of the postulated goal conflict as a mere modeling convenience, arguing: "the role of this [overambitious] employment target is to introduce a benefit from a surprise inflation." True, within a New Classical game setup, such "conveniences" may indeed be needed to get the whole story off the ground. But that is hardly any excuse. The problem is that from a Keynesian perspective, the postulated behavior of policymakers reflects *outright irrationality* (cf. Blinder 1998 and Forder 1998a). Referring to situations of less than full employment, Keynes ([1936] 1973) argued that in such conditions a *temporarily* expansionary monetary policy might *permanently* raise employment toward full employment. The aim of

discretionary policies is to stabilize an unstable economy, not to resort to deliberate surprise inflation in order to push employment beyond its equilibrium level. Pushing employment beyond equilibrium when inflation is at the optimal rate simply makes no sense, particularly as *costly* disinflation would have to follow.

The standard time inconsistency model is not robust to relaxing its assumption of the nonexistence of Friedman's "long and variable" lags in the monetary policy transmission mechanism. If proper account were taken of time lags, the time-inconsistency issue becomes a nonstarter. Real world monetary policymakers simply do not possess the imaginary powers necessary to transcend the lags and spring inflation surprises (Goodhart and Huang 1998). Making nonsense of both Keynes and Friedman, New Classical time-inconsistency modelers truly made fools of themselves in erecting a benevolent dictator fiction in disguise (Bibow 2004).

That said, it is easy to see that real world independent central bankers, should they allow themselves to be guided by such fallacious New Classical ideas, could become a serious threat to economic performance and welfare, as well as democracy, which leads me to Post Keynesian criticisms of CBI—CBI as presented in this peculiarly confused New Classical–inspired literature.

4. POST KEYNESIAN CRITICISMS OF CBI

Compared to mainstream writings in which the topic of CBI featured among the most fashionable subjects since the 1990s, Post Keynesians have paid relatively little attention to the issue. Quantity is not a measure of quality though. The positions reviewed in this section provide a spectrum of views on some critical aspects of CBI that will inform our discussion of Keynes' own ideas on CBI in the subsequent section.

Observing that the rise in CBI occurred in a climate that increasingly viewed price stability as the true or "natural" goal of monetary policy, Carvalho (1995–96) argues that granting independence may be seen as the central bank's liberation (and "hidden agenda") supposed to allow it to focus on just that. Offering his Post Keynesian take on the issue, Carvalho finds independence generally acceptable if it means that the central bank is "not required to sacrifice monetary policy goals in order to compulsorily accommodate fiscal policy decisions" (Carvalho 1995–96: 166). By contrast, he finds much less acceptable that the central

bank should be “able to implement monetary policies in a direction contrary to that decided by the central government” (Carvalho 1995–96: 166). One issue is that monetary policy has to be coordinated with other economic policies, another than the mainstream case for CBI with its price-stability focus resting on the natural rate of unemployment hypothesis, whereas Keynesian monetary theory, Carvalho emphasizes, relies on the nonneutrality of money: “Once one rejects the natural rate hypothesis, the proposal of independence of the central bank to set its own goals and to pursue them as it feels fit makes no sense,” Carvalho (1995–96: 172) concludes.

Rymes (1995–96), too, focuses his critique of CBI on the critical mainstream assumption of money neutrality. In his view, “the nature of the central bank problem changes from the need for a rule with respect to *price stability and prices stability only* and accountable autonomy, to judgment with respect to the real effects the central bank has upon the economy and the need to subject that judgment, whose characteristics cannot be reduced to simple rules, to the continual scrutiny of the government and the democratic electorate” (Rymes 1995–96: 185). Note that Rymes refers to “accountable autonomy” in the above quotation. He offers an important clarification regarding government responsibilities and democratic control, highlighting that even if the mainstream case for CBI were accepted “the central bank must be made responsible not for price stability, which is a government responsibility, but for the production of such stability. The government determines what price stability means and the central bank must meet those targets. This accountability enhances democratic control and hence political welfare” (Rymes 1995–96: 178–89). This would seem to address Carvalho’s concerns about the central bank setting its own goals, but the issue remains that an exclusive focus on price stability makes little sense if monetary policy is nonneutral. In fact, Rymes concludes that once it is acknowledged that modern monetary systems are not of the costless fiat money type featuring in mainstream models “the economic and political theoretical case for an autonomous and accountable central bank collapses” (Rymes 1995–96: 186).

Starting from the observation that the question of CBI is really “one of degree,” Levy (1995–96: 189) focuses on the issue of whether CBI, in conjunction with the exclusive pursuit of price stability (cum financial stability), might violate democracy. In his view, two conditions would have to be met for CBI to be consistent with democracy. First, that monetary policy has only narrow consequences, affecting price stability and financial stability, but without involving “social trade-offs.” Second, that the “central bank has a systematic, objective method of selecting

the right policy" to meet its narrowly defined goal. Levy (1995–96: 191) believes that neither of these conditions holds in reality. He therefore concludes that "democracy requires that CBI be limited so that the makers of monetary policy cannot stray far from the will of the people as embodied in their duly elected representatives. Moreover, central bankers must be held accountable for all of the ramifications of their policy, not just the inflation rate." Concentrating on the case of the U.S. Federal Reserve System, he criticizes the fact that the selection process would favor bankers over more representative and diversified interests and recommends that Congress must extend rather than reduce its oversight and accountability measures over the Federal Reserve. [In June 2010, this may be about to be changed; JB].

Also weighing in on the debate on CBI in the *Journal of Post Keynesian Economics* is Bernard Shull who concentrates his analysis on the Federal Reserve System. Shull (1995–96) considers the historical roots of the Federal Reserve as explaining the nature of its independence, observing that the "design of the Federal Reserve sprang not so much from the concern that the policies of the central bank would be corrupted by political influence, as from the fear that the government was being corrupted by its involvement in banking" (Shull 1995–96: 217). Addressing the issue of "what kind of independence and how much," Shull attributes "policy instability" to a diagnosed "constituency problem," with the Federal Reserve, by historical design, being subject to possibly conflicting pressures from Congress, the Administration, and commercial banks. He concludes that "more, rather than less, independence is needed" (Shull 1995–96: 225), proposing to increase the number of public members on Reserve Bank boards and lengthening the effective terms of governors.

Concentrating on the Federal Reserve as well, Bartel (1995–96: 248) reaches the opposite conclusion and suggests that "reining in CBI is long overdue." His two main criticisms concern money nonneutrality and the links between monetary policy and bank regulation. On the former he stresses that the Fed's anti-inflation efforts impact on the distribution of income and wealth "as powerful[ly] as any changes in federal tax policy. Congress, however, can pass tax legislation affecting income distribution only after the most excruciating public scrutiny, and then the president must sign it. The Federal Reserve, on the other hand, has no such built-in checks and balances." On the latter he finds that in an "ideal world" the central bank should have broad regulatory powers as well, but judges that in view of the Fed's actual track record in this area reducing its powers and independence may be called for instead.

Offering a chartalist perspective on the matter, Wray (2007: 2) argues that an "effective central bank *cannot* be independent as conventionally defined, where effectiveness is indicated by ability to hit an overnight *nominal interest rate* target." At one level Wray's argument is about central banks' operating procedures that typically aim at making a particular target short-term rate of interest effective in money markets, procedures that require coordination with the Treasury's liquidity and debt management so that the banks' liquidity requirements are accommodated at the target rate. At a more fundamental level, the argument is about sovereign governments' power to spend in a currency declared legal tender and required by subjects to pay their taxes in.

Of course, sovereign governments' ability to run deficits in their own (legal tender) currency is the basis for modern concerns about "fiscal dominance"—a Treasury forcing the central bank to monetize public debt (Sargent and Wallace 1981). Historically this fear provided the rationale for prohibitions of loans to the government or direct purchases of government debt securities. Wray argues that "such independence is wholly illusionary" (Sargent and Wallace 1981: 3). Ultimately, it would seem, the only check against (hyper-)inflationary deficit spending is government self-restraint. And we may then also add that, from a "functional finance" (Lerner 1944) perspective, popular fears of *too large* deficits appear rather one-sided, as they ignore inefficiencies arising in the opposite case of *too small* government deficits and/or insufficient liquidity provision by the central bank (i.e., debt monetization in one way or another). Wray also refers to a "second dimension" in the CBI argument that is about freedom from political manipulation. He rejects the idea that central bankers might operate in some kind of vacuum free from ideology and special interests, not least because the Federal Reserve is ultimately a creature of Congress and will therefore always pay due attention to the body politic. Especially in view of the points raised above regarding democracy and cooperation, arguably, anything else would seem rather troublesome.

To conclude, if we may take the spectrum of views reviewed in this section as representative, it would appear that Post Keynesians are far more critical of CBI than the mainstream. Particular concerns are raised regarding policy coordination[10] as well as democratic control and accountability. Furthermore, to Post Keynesians the assumed neutrality of monetary

[10] Post Keynesians are not alone in stressing the need for policy coordination. Doyle and Weale (1993) argue that costs that may arise from a failure of coordination between two independent authorities could outweigh any supposed benefits of CBI.

policy in mainstream thinking presents the overarching issue in the whole matter. The next section will discuss Keynes' own ideas on CBI, focusing on the question of whether the CBI model outlined by Keynes in 1932 meets these important Post Keynesian concerns.

5. DOES KEYNES' MODEL OF CBI STRIKE A SOUND BALANCE BETWEEN DEMOCRACY AND EFFICIENCY?

Keynes commented on aspects of, and questions pertinent to, CBI on numerous occasions. One such occasion was in 1932 in response to a policy pamphlet by the Labour Party, demanding democratic interference in monetary policy. At the time, Labour proposed that the central bank governor should be subject to the general direction of a Cabinet minister, who, in turn, should be responsible to Parliament for monetary policy. This arrangement was unlikely to be conducive to efficiency in conduct of monetary policy, in Keynes's view a "difficult technique" that required expert technicians. Keynes viewed CBI as an appropriate means to secure the "utmost decentralisation in the handling of expert controls" (Keynes [1932] 1982: 131), and generally regarded the independence and prestige of the Bank of England as assets. Crucially, his response makes it clear that he envisaged a specific *form and degree* of CBI that was based upon checks and balances intended to constrain the technicians' scope for discretion while establishing ultimate—though indirect—democratic control over monetary policy at the same time.

Keynes summarized his position on the independence of the Bank of England in the form of "five propositions as embodying the essentials." The first proposition reads: "The interest of private shareholders in the profits of the Bank, nominal though it now is, should altogether cease" (Keynes [1932] 1982: 131). Contrary to his views on this particular aspect held at earlier times, by 1932 public ownership was a clear-cut case to Keynes. His second proposition underlines the first, stressing that the central bank be put on a secured track and that it be seen as a disinterested public body, pursuing nothing but the national interest: "The Bank should be expressly recognized as a national institution from which private profits and private interest are entirely excluded. The directorate should be selected on public grounds and should not stand for the interest of the City any more than for other national interests" (Keynes [1932] 1982: 131).

Departing slightly from his ordering of propositions, Keynes reserved proposition 5 for the issue of openness and transparency in policy conduct, arguing that: "The day-to-day policy of

the Bank, its statistics, its technique, and its immediate aims and objects should be as public as possible, and should be deliberately exposed to outside criticism" (Keynes [1932] 1982: 131).

The remaining propositions concern the issue of public control of the central bank, describing the core principles of division of responsibilities. Contrary to the Labour proposal of exercising democratic control by direct subordination of the central bank governor to a minister of cabinet rank, Keynes wanted the central bank to cooperate on an even level with the Treasury, while reserving ultimate responsibility over monetary policy for the government, which, in turn, is subjected to parliamentary control.

Keynes third proposition of 1932 reads: "The management of the Bank should be ultimately subject to the Government of the day and the higher appointments should require the approval of the Chancellor of the Exchequer" (Keynes [1932] 1982: 131). Keynes' subsequent discussion shows that the crucial role of the government of the day was to decide the "main lines of policy." The limits for the government to stipulate its ultimate goals of policy are then captured in Keynes' fourth proposition, which foresees that "the principles of the currency system, e.g., whether or not the standard should be gold, or whether stability of wholesale prices or of the cost of living or of some other index, is to be its norm, should be determined by Parliament" (Keynes [1932] 1982: 131).

As if to balance these various checks on the central bank's scope for discretion, as imposed by Parliament's "norm," the "main lines of policy" of the government of the day, and informed outside expert criticism assuming transparent policy conduct, Keynes adds a sixth proposition, supposing the other five were accepted. The sixth proposition affirms his opposition to Labour's proposed form of democratic control, establishing a principle meant to guarantee that expert opinion dominates where it should. The principle reads: "The less direct the democratic control and the more remote the opportunities for parliamentary interference with banking policy the better it will be" (Keynes [1932] 1982: 131).

This last proposition underlines that Keynes was equally concerned with democratic principles as with economic efficiency, which he thought was dependent on expert control, in normal circumstances operating without *direct* parliamentary interferences. How does Keynes' CBI model fare with regard to the above Post Keynesian criticisms? Addressing this question is somewhat complicated by the fact that Keynes generally refers to the British system of government (and, on some occasions, to the situation in the British India) whereas the above Post

Keynesian contributions largely focus on the American one. Nonetheless it seems to me that Keynes' vision on these matters becomes clear enough to allow at least a broad translation across systems in most respects.

To begin with, while Keynes saw important value in decentralizing the handling of the central controls (and not having the Treasury in charge of macro and financial policies alone, that is), he clearly emphasized the need for close cooperation between the authorities. The "main lines of policy" to be laid down by the government would provide the forum for policy coordination between the central bank and the Treasury—on equal terms. The independent central bank would be in no position to set its own goals. Expressed in modern terminology, Keynes favored instrument, but not goal, independence (see Debelle and Fischer [1995]). Keynes did not wish to subordinate either of the two key players to the other, but stressed that they must always work together and pursue an agreed policy. This crucial issue is made very clear in his evidence to a Royal Commission on Indian Currency and Finance in 1926. Questioned on the issue of subordination or cooperation between the Bank of England and the Treasury in matters of monetary and exchange rate policies, Keynes observed that:

> … you can have two bodies which maintain their respective spheres of responsibility and of power and yet necessarily always work together. It is the fundamental question of the relation between any central bank and any Treasury. In a sense in any country it is quite unworkable that the two should be in antagonism. Therefore you might say, as a logical consequence of that, that one must be in subordination to the other, but I hope that is not true in practice, but that you can have two bodies neither of which is subordinate to the other but which must always act in co-operation with one another. It is a dilemma which you get in other spheres of government. My view in this country of the future of regulation would be that the Treasury and the Bank of England would be neither subordinate to the other but would always be pursuing the same policy. That may sound impossible, but I do not think it is. (Keynes [1926] 1981: 512)

When the questioner then tried to pin him down on whether or not the government would retain responsibility for varying the rate of exchange, Keynes affirmed and further elaborated:

> I conceive a central bank not as something which is independent of the Government in the sense in which a Bombay cotton mill is independent of the Government, but as an organ of the Government which has a certain independence of the executive; that is to say, that it is not a subordinate department of the Treasury, but is an organ of the Government on a level of authority with the Treasury. I think there is apt to be confusion between the Government as a sovereign body getting rid of responsibility, and some particular department of Government like the Finance Department, which at present has responsibility, having less responsibility. I think the change would mean that the Department of Finance would have less responsibility than it has now, but the Government of India, in a broad sense, would have just the same amount of responsibility as it has now. It is impossible to conceive a sound system in which your central bank was really a private thing and was not subordinate to the sovereign instructions of the Government. (Keynes [1926] 1981: 512–13)

In my view, Keynes' model does indeed meet the central Post Keynesian concerns about policy coordination and democratic control and accountability. In line with Thomas Rymes' point, the central bank is not made responsible for price stability (or any other goals as laid down by the government) but for the *production* of price stability. The government remains responsible for whatever goals the central bank is trying to achieve and is accountable for the results to Parliament and the electorate. The central bank itself only faces indirect democratic control and accountability. The central bank technicians would neither be elected by, nor directly accountable to, the public. In Keynes' arrangement, the line of accountability for performance on the government's remit would run from the central bank to the government of the day, which, in turn, would be accountable to Parliament for overall economic policy performance, and thereby to the electorate. The central bank is tied to the policy remit laid down by the government and obliged to cooperate with the Treasury, on equal terms.[11]

The issue of cooperation attains a special urgency from the chartalist perspective, both at the technical level as well as with regard to the fundamental—functional finance—matter of whether the (independent) central bank might chose to obstruct government policy by lending inadequate monetary support to government spending aimed at full employment. At the purely technical level, close coordination between monetary policy (open market and repo operations)

[11] Forder (2003) provides a thoughtful analysis of the critical political legitimacy issue, although his discussion may be too much framed by the mainstream treatment (or, rather, neglect) of the issue.

on the one hand and Treasury debt management and liquidity policies on the other is a precondition for making any particular target level of interest effective in the market, as already emphasized by Keynes in the *Tract* concerning the short rate and later extended to longer-term rates in *The General Theory* (and after). From a chartalist perspective, the situation is probably best handled by having the Treasury hold its current account, including an overdraft facility, with the central bank (much in line with the central bank's historical role as "government's banker").

Obviously Keynes was well aware of the inflation potential of the printing press as, for instance, his analysis of the "inflation tax" in the *Tract on Monetary Reform* shows. In the *Treatise on Money* he observed that legally constraining the central bank's discretionary powers over the note issue as an "indirect means of avoiding its being subjected to imprudent financial demands of the government" was both ineffective with respect to its purpose as well as operationally harmful. Ultimately, in a managed currency system, price stability can only be anchored by the political will of those charged with responsibility over economic policy. Keynes' CBI model refers to conditions of democracy. As to the "right principles of regulation" Keynes states: "I believe that, in any civilized country with a responsible government and a powerful central bank, it would be much better to leave the management of the reserves of the central bank at its own unfettered discretion than to lay down by law what it should do or within what limits it should act."

Turning to the fundamental issue of whether an independent central bank might obstruct government policies aimed at full employment, we are in fact dealing with the money neutrality proposition, which is at the heart of much Post Keynesian opposition to CBI. Recall that from the time-inconsistency perspective the independent central bank's whole purpose, in a sense, is to oppose government policy because government policy, *by assumption*, aims at more-than-full employment—giving rise to that infamous inflationary bias in long-run equilibrium. There appears to be no conflict with democracy because there are no real costs, by the money neutrality assumption, while lower equilibrium inflation is welfare-enhancing, by assumption. The opposite Post Keynesian concern is that an independent central bank might misuse its powers to effectively condemn the economy to being stuck in a less-than-full employment equilibrium permanently, and without proper democratic accountability despite the huge real costs thereby imposed on society. How come Keynes did apparently not consider his CBI model as problematic regarding the non-neutrality of monetary policy?

The fact that his CBI model of 1932 predates his discovery of the principle of effective demand is not the answer. Already in the *Tract*, Keynes dismissed the practical relevance of the neutrality postulate as a guide for economic policy, famously reminding the economics profession that in the long run we would all be dead (while in the short run economists should better prove their usefulness).[12] Instead, the crucial point is that the neutrality postulate concerns policy conduct, while CBI concerns the structure of monetary policy. Keynes' argument is that a sound structure would tend to improve the quality of conduct, though in a technical sense concerning the production of policy goals, whatever these may be, rather than concerning the choice of goals, which, in his view anyway, is the government's prerogative. It matters to the government's choice of policy goals whether it subscribes to the neutrality postulate, but the central bank is no party in this; its job concerns the delivery on those goals, whatever they may be.

For instance, if the government believed in money neutrality and pursued price stability as its sole policy goal (and equally for Parliament and the electorate from which the policy mandate is ultimately derived in a democracy) why should it be better to have a dependent rather than an independent central bank, even if money were actually nonneutral? Presumably it could matter if the independent central bank did not share the government's belief and paid too much attention to its own employment goal. If this resulted in a threat to the government's sole price stability goal, this could force the government to compensate by other means. While representing the opposite scenario to the one featuring in the time-inconsistency fiction, the point is that in Keynes' CBI model such confrontations are illegal. The central bank's role is to "produce" the desired results, not to have its own agenda. The same applies in the alternative scenario in which the government has all good intentions to focus policy on full employment, fully understanding that money is nonneutral, while the central bank obstructs this policy following its own beliefs in the neutrality postulate. Perhaps this might seem to be the most relevant case from a Post Keynesian perspective, but in Keynes' CBI model it is the government's responsibility to decide on the policy goals that the central bank is expected to produce, facing both outside expert scrutiny as well as parliamentary accountability. Furthermore, it is for the government to appoint

[12] None other than Milton Friedman confirms Keynes on the practical relevance of the neutrality postulate. Friedman (2002: 366) finds it "baffling" that Otmar Issing (chief economist at the ECB at the time, who had previously held the same position at the Bundesbank) suggested that a prudent central banker might get comfort from the money neutrality proposition, quoting Keynes's famous remark about the long run in which "we are all dead."

central bankers. If the choice falls on candidates believing in money neutrality, then this is precisely what the government wants, presumably.

In short, the balance of arguments in favor or against CBI does not hinge on money neutrality. Rather the real issue is whether any particular kind and degree of CBI represents a sound balance regarding both efficiency as well as democracy—efficient in the production of what it is asked to deliver and democratic regarding the principles in which government and central bank accountability are organized. Keynes held that the CBI model he outlined in 1931 would offer such a sound balance.

A discussion of the German CBI model might serve to highlight some crucial differences here. In the German model the government may lay down targets for employment, price stability, and any other goal it considers an important part of its program. Yet the Bundesbank law says that the Bundesbank's *primary* objective is price stability, leaving it to independent central bankers to decide what they regard as price stability and whether they deem it possible to support any other goals beside price stability. Responsibility for price stability, and not just for the production of price stability, is passed over to the independent central bank, which operates as a *separate* policymaker with its *own* price stability goal. In practice the Bundesbank denied responsibility for anything else but price stability—for which the government no longer feels responsible.

Given the complete lack of democratic accountability in this model, central bankers have propagated the idea that they would somehow be directly accountable to the public. This makes the situation far worse, since it means that central bankers are effectively competing with the government in wooing the public, while only the government is facing regular elections. Independent central bankers may then be tempted to see public confrontations with the government as a chance to foster their own standing and reputation.

It is easy to see that the German CBI model conflicts with basic democratic principles and may easily be operationally inefficient in leading to persistently high unemployment and slow growth, unless the government finds other ways to stimulate growth (or the central bank's primary price stability goal can be relied upon to deliver growth, for instance, through exports). From the perspective of the time-inconsistency literature, the German CBI model looks attractive because of Germany's low inflation record, while any detrimental real effects are denied by assumption (conveniently abstracting from issues of democracy, too).

On the one hand, the German model, once established, can make it hard for any government to change if central bankers mobilize public support for their cause and protection. Inheriting the German CBI model, the ECB has yet to match the Bundesbank in rallying public support for its peculiar ways, but its status of independence has become constitutionally anchored with the Maastricht Treaty on EMU and is unlikely to disappear without the disappearance of the euro itself. On the other hand, the government may not want to change the situation anyway since it basically shares central bankers' beliefs and policy priorities, which will become visible in the government's choices of central bankers in particular.

Post Keynesians may have every reason to criticize both the money neutrality postulate and the time-inconsistency argument for CBI, and there may also be plenty of scope for criticisms of central bank conduct, but the real targets for criticism are to be found in government and among expert opinion, namely for subscribing to the neutrality postulate and selecting central bankers from the same church. To repeat, it would be hard to see any benefits from central bank dependence if these other fundamental factors stayed the same. Keynes saw CBI as a way of achieving a "decentralization in the handling of the central controls," which he believed would bring efficiency gains in the production of *whatever goals* a government may wisely or foolishly chose to pursue.

6. CONCLUSION

Post Keynesians are well-advised to show concern for institutional arrangements of government. An important monetarist and public choice critique of Old Keynesianism was that it seemed to assume a benevolent dictator in control of government policy. The concept of CBI concerns institutional arrangements of government, more specifically the structure of monetary policy. It is of course ironic that the New Classicals in their blind witch hunt of Keynesian ideas unwittingly re-erected an especially foolish benevolent dictator version in the form of independent central banks. The modeling world from which their policy prescriptions, including favoring CBI, are derived has nothing in common with central banking on this planet and the New Classical time-inconsistency fiction is of zero practical relevance. But that does not rule out that CBI, if properly designed (including assured compatibility with democratic principles), might not contribute toward efficiency in policy conduct.

As on so many other issues, Keynes' ideas on the matter provide a good starting point for serious thinking. Keynes clearly understood that the issue was not to maximize CBI, but to find a suitable design of a particular form and degree of central bank independence that would both tend to be conducive to the efficiency of policy conduct as well as compatible with democratic values. The rise in CBI is certainly not a success story in modern monetary economics, but is—seen globally—probably an outgrowth of neoliberal ideas and of a general withdrawal of government and shift in favor of markets. In the European context, historical accidents and peculiar German traditions provided by far the most important influence. The continental European example also shows that maximizing CBI may be both detrimental to efficiency and in conflict with democratic principles. The crisis in Euroland in 2010 illustrates in all too many ways the foolishness of a policy regime obsessed with protecting the independence of the central bank above all else, including the absurd idea that balancing the government budget is both a necessary and sufficient condition to achieve that end—which in turn would guarantee bliss in the best of all possible worlds.[13]

The global crisis that started in 2007 has also reminded us that even the most orthodox beliefs held with all stubbornness may get challenged at some point. At least some independent central banks have shown pragmatism in cooperating with the fiscal authorities. And in matters of financial regulation and supervision, too, the role of central banks (in their historical role as "bankers' bank") is becoming newly reconsidered in ways that may also pertain to the structure of monetary policy. Even the world of independent central bankers is in flux.

[13] Bibow (2009b) investigates the failure of the German CBI model and German export-led growth model as applied at the European level.

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