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REVIEW ARTICLE

The new normal? Central banks as social insurers and reputation-protecting political agents

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Abstract

An *idée fixe* of Great Moderation economic policy was that central banks are only effective macroeconomic managers when they are segregated from electoral politics. That idea made a swift transition from radical heterodoxy to commonsensical orthodoxy during the 1980s and proved remarkably resistant to reality during the 2008 financial crisis. After almost twenty years of 'unconventional' monetary policy, scholars, policymakers, and politicians are justifiably searching for more credible ways to conceptualise and use the nation-state's monetary authority. Two recent books provide vital energy for that intellectual exercise. Éric Monnet's *Balance of Power* is a bold re-conceptualisation of monetary authority as a welfare-state support in liberal democracies. In addition to dissipating the illusion that central banks are simply interest-rate-setting inflation-fighters, Monnet presents a systematic argument for integrating them into a web of deliberative institutions (including public development banks and economically empowered parliaments) to bolster the legitimacy and effectiveness of monetary policy. Relatedly, Manuella Moschella's *Unexpected Revolutionaries* attacks the idea that central bankers are responsive only to technocratic doctrine and private-market behaviour, showing how monetary authorities sculpt policies to bolster their reputation with political actors. Paying close reference to private-market liquidity guarantees and quantitative easing, Moschella maps the fortunes of unconventional policy in alignment with political support for financial-market backstops and exceptional economic stimulus. Both books provoke readers to jettison the anodyne generalities of central banks' own glossy pamphlets and think afresh about the possibilities of economic policy's new normality.

Keywords: Central banking; crisis; monetary policy; social insurance; welfare states

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A family drama within modern economics played out in the Eccles Building's Board Room in March 2013. A Fed research team's memo that modelled the fiscal implications of large-scale purchases of US Government debt was presented to the Federal Open Market Committee (FOMC). Governor Jerome Powell had requested it to bolster a communication plan to persuade Congress of the benefits of quantitative easing ('QE').

The results confirmed the long historical experience of using central banks to backstop fiscal responses to acute and chronic economic crises. The Fed economists explained that '[m]onetary policy is at all times inextricably linked with fiscal policy [and] . . . It is fairly common for central banks, independent or otherwise, to take actions with direct fiscal implications in certain, typically difficult, circumstances' (Federal Reserve Board Staff, 2013). Relying on the Fed/US in-house model, the researchers found that $500 billion in 'additional asset purchases [would] decrease outstanding federal debt by about $300 billion by 2025, a change equivalent to a 1.4 percentage point reduction in the federal debt-to-GDP ratio'. That would be cheery news to the heavily indebted US Government, servicing debt on an enormously expensive bank-rescue scheme and a modest new-Keynesian stimulus package.

It was less pleasing to some Fed officials. The hawkish case was presented by the President of the St Louis Fed:

> I disagree with attempts to characterize monetary policy as facilitating a better fiscal position for the U.S. government. My view is like this. We have a 2 percent inflation target. That produces seigniorage revenue, which in the steady state would be around $20 billion in normal times ... This is the only contribution of the central bank to the long-run fiscal situation in the United States. Monetary policy is neutral in the medium and long run. Stabilization policy mitigates fluctuations to keep the economy closer to the balanced growth path than it would otherwise be, but this has no implications for real revenue to the government over the business cycle because the highs are lower ... and the lows are higher than they would otherwise be. You're attenuating the business cycle. So I don't think that we should claim that there's anything that the central bank can do to improve the fiscal situation of the U.S. government. (Board of Governor of the Federal Reserve System, 2013: 252 [Bullard])

That vision of monetary policy focused entirely on the private market was presented as natural law. Its non-political identity was axiomatic. Governments were economic agents like any other, subjected to the business cycle and subordinated to central bank stabilisation. The need to control inflation set the limit of fiscal policy. Whatever the Fed's quantitative models found, it must never be publicly 'claimed' that the monetary authority could support national economic plans.

Perhaps the debate was just an insular status game played by the Fed's freshwater macroeconomic grandees (such as James Bullard) and economically untutored newcomers (such as Powell). But it has echoes of a global clash of ideas over the legitimate structure of economic power. Before that episode, Bank of Japan officials made (ultimately futile) pleas for the Japanese Cabinet to cease making 'comments about the conduct of monetary policy, especially outright purchases of [Japanese Government Bonds] by the Bank, on occasions such as their press conferences' (Bank of Japan, 2002). After the FOMC imbroglio, German central bankers threatened to (and did) resign from the European Central Bank in protest against European monetary authorities' support for public-debt markets. The eerie replication of these dynamics across time and space hints at deeper turbulence in the current economic thought.

Two books have recently been published which provide vital assistance in unpicking the historical drivers of these dynamics and planning a way forward: *Unexpected Revolutionaries*, by Manuella Moschella (2023), and *Balance of Power*, by Éric Monnet (2024).[1] Although emerging from different disciplinary homes, both works make timely contributions to scholarly discourses within economics, political economy, political science, and sociology.

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Monnet's book is a bold reformulation of the terms of debate on the legitimate role of monetary authority in a democracy and the reform possibilities for central banks after decades of insulation from political will and social policy. The work's deep contribution is to provide a systematic argument for reorientating discourse away from the nostrums of Great Moderation consensus, towards a new set of concepts which recognise the embeddedness of monetary authority within the broader network of state power in democracies.

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Monnet opens with a meditation on the importance of viewing central banks as part of government and inseparably connected to the growth of welfare states. He states his case for understanding central banks' essential 'insurance function' (more on that below) and then spends substantial time elucidating arcanely technical matters of central banking for the non-specialistic audience. With elegance and ease, he places central banks within the constellation of financial institutions (public and private) before moving on to explain the practicalities and implications of central banks' power to create money 'from nowhere'. This aspect of Monnet's book can be understood as a contemporary refresher on the long literature trying to disentangle Adam Smith's pseudo-ethnography of money, including Michell-Innes (1913), Humphrey (1985), Desan (2015), and Graeber (2013). The necessity of that exercise underscores the historical illiteracy assumed in the Econ 101 recitation of fiat money as a unique phenomenon created *ex nihilo*. As generations of monetary historians have explained, *all money* is created by force of law or enabled by a dense network of public norms and institutions, rather than created 'by the market, for the market'. Joining that chorus, Monnet manages to link central banks' money-creation powers to long-run inequality, financial market de-risking, prudential regulation, and the (thrillingly esoteric) topic of monetary authority bankruptcy.

Monnet then broaches a set of topics which are vital to the ontology of central banks, yet wholly absent from the anodyne trinity of contemporary monetary policy (price stability, interest rates, and independence). Monetary authorities – whether dependent, independent, or innominate – have an historically settled reaction to public solvency crises: they buy large quantities of government debt to backstop the government. Monetary authorities are also and always have been active agents in foreign-currency markets, lending their own currency and borrowing FOREX – again, in vast quantities. These are deeply awkward truths for proponents of the macroeconomic consensus to discuss. Maintaining the myth (an apolitical domestic interest-rate setting central bank) in the face of reality (a public-deficit backstopping central bank with geopolitical functions in international sovereign credit markets) is possible because the institutional facts are so complex. Monnet's work here provides an illuminating and digestible primer on those topics. The coverage of digital currency is more impressionistic, but a necessary addition to those dynamics given the prominence of 'central bank digital currency' in proactive reformulations of economic order, such as Omarova's (2020) 'The People's Ledger'.

Three core ideas animate the book: one theoretical, the other two institutional and practical.

The first is the core 'insurance function' of monetary authorities, which is linked to the insurance theory of the welfare state 'investing and regulating today in order to avoid paying compensation tomorrow' (6). Monnet arrives at this formulation through historical examples of central banks deploying their money-creating powers to protect against the vicissitudes of markets and politics, while always focused on 'the value of money'. Thereby, central banks are depicted as institutions of 'decommodification' designed to 'reduce individuals' dependence on, and vulnerability to, the forces of the economic market' (32). Monnet explicitly locates this idea within the canon of modern central banking (quoting Goodhart [1998]) and it is hard to escape parallels with Avner Offer's work on the role of state institutions in providing insurance against periods of life-cycle dependence.

Monnet makes two pleas to the reader to defuse the 'paradoxical' appearance of placing a central bank (the institutional focal point of profit-driven financial intermediation) inside a category with 'institutions like a public pension system, a public hospital, or education'. We must assume a social model in which banking/financial institutions are permanent features. We must also (following Polanyi) view central banks' pursuit of a stably-valued *numeraire* as a 'device intended to provide the protection, without which the market would have destroyed its own children' (33). Whether this is convincing depends very much on readers' susceptibility to utopianism and their customary interlocutors.

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Clearly, Monnet works in a tradition which rejects, as descriptively plausible, any idea of self-correcting markets, while allowing private finance a socially constructive role and viewing the monetary authority as the ultimate shield against market failure over the long run. Keynesians will delight, others may not.

Adopting a conciliatory tone throughout, Monnet does not fixate on central banks' failure to achieve the aims he sets, although he admits they are not always successful insurers. If a more oppositional posture were taken, Monnet could have observed, for example, the historical role of central banks in welfare-state constraint, whereby monetary policy was openly discussed as a 'tighter rope round the [Finance Minister's] neck' (Needham, 2014: 91). He could also have visited central banks' recent role in powering the carnival of financial-asset inflation from 2007 to 2022 and the tragedy of wealth inequality left in its wake. That story features heroes and villains within central banks, as some monetary policymakers were vocal about the foreseeable injustice of their 'unconventional' policies:

> The essence of [QE] relies on a segmented markets view of the world, where there are some people participating in bond markets and other people who have less access to it . . . The people who are participating in the markets are the ones who benefit from this. The ones who are not participating are the ones who don't benefit. Typically I would think the people who are participating in asset markets are wealthier and more educated, while the people who are not able to are less wealthy, less educated. (Board of Governor of the Federal Reserve System, 2011: 166 [Kocherlakota])

Exactly who or what was insured through QE policies is an interesting subject for detailed examination.

The book's second core idea is that central banks should neither be confused with, nor become, public investment banks, nor be collapsed wholly within treasuries. Thereby, Monnet depicts central banks' role as a 'pillar of the financial system but not to independently define the function of finance in the economy' (33). Again, historical empirics drive that analysis, with Monnet observing the development of public investment banks as funders of social infrastructure and low-cost competitors to commercial banks, particularly in Europe. Excluding central banks from that function allows competition and specialisation between different forms of finance and prevents imperial concentration of financial power in the monetary authority. Monnet's bifurcation has compelling historical analogues in Western Europe and he recognises work drawing a similar boundary in the Anglosphere, discussing Saule Omarova's (2022) proposal for a National Investment Authority in the US. Ultimately, Monnet's point is to resist the temptation to formulate projects for critique and reform which assume a central bank which worries itself with the funding of project X or Y at rate A or B. That limit has negative consequences for proposals to start green monetary policy operations or variable interest-rate policies for social development and public investment. Its strength depends on which part of history one appraises and the predictable severity of, for instance, the climate emergency. Anyone who has read a central banks' annals during total war would be puzzled by the idea that a central bank stands aloof from questions of public investment or capital allocation during severe multi-year crises. Even during periods of intense peacetime industrial development, integration of central bank functions into public investment processes is observable – as can be seen in Allen's documentation of the Bank of England's use of asset purchases to fund the nationalisation of the UK coal industry in the 1950s (Allen, 2018: Chapter 7). If the expression 'climate emergency' is taken literally, it is hard to imagine central banks not subsuming (at least, in part) the financial roles of public development and commercial banks over the long haul.

Monnet's third core idea is that deliberative bodies, 'Credit Councils', should be developed to enable cooperation between central banks, public investment banks, treasuries, and private capital. This concrete proposal is inspired by Monnet's historical work on the French *Conseil national du crédit*, which operated during the *Trente Glorieuses* and was masterfully documented in his earlier monograph, *Controlling Credit* (Monnet, 2018). Monnet makes the point that overreliance on central bankers by other governmental bodies is driven by a towering imbalance between the expertise and capacities of people working inside and outside monetary authorities. Without a mechanism to correct that imbalance, the incompleteness of central bank mandates can only ever be filled by technocratic behaviour within central banks, with parsimonious consideration of the democratic will and a corresponding intellectual atrophy. Monnet closes the book by speaking about the importance of approaching major economic challenges (the green transition, inequality, and fiscal-monetary cooperation) through the lens of deliberation. The somewhat allusive tone fits his commitment to resolving socio-economic policy through meaningful deliberation, rather than technocratic fiat.

Monnet's approach to deliberation between central banks and public economic actors has obvious resonance in economies with hardcore central bank independence norms, such as the European Union, in which central banks are legally enjoined from 'seek[ing] or tak[ing] instructions' from any governmental authority (Treaty on the Functioning of the European Union, Article 130). In such a system, his proposal is sharply strategic. Arguing for a revocation of central bank independence in the EU implies a complete renegotiation of the European geopolitical compact, with existential implications. His second-best solution is very attractive under those constraints.

In less sclerotic constitutional orders, Monnet's proposal seems necessary but insufficient. It is obviously desirable to correct the inequality of intellectual arms between governments and central bank-aligned economists, and deliberative fora like a credit council may work towards that end. But it is not obvious that proposals for reform should stop there. Why not simply inject government representatives directly into monetary authority deliberations? Why shouldn't central bank legislation be amended to declare central bank's insurance functions and stipulate that social and political impacts be mandatory considerations for monetary policymakers?

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The customary (abbreviated) response to these questions is that an advanced economy which took those steps would lose credibility with investors, particularly bond and currency traders, who would punish the politicisation of money by dumping assets ahead of inflation. That position assumes the correctness of theories generated in the 1970s, particularly by rational expectation scholars within the new classical school, and expresses policymakers' traumatic memories of moments like Black Wednesday in 1992. The durability of 'investors will punish you' arguments is strange given the quarter-century of contrary practice in, for example, Japan, where the central bank has been legally required to 'always maintain close contact with the government and exchange views sufficiently, so that its currency and monetary control and the basic stance of the government's economic policy shall be mutually compatible' (Bank of Japan Act, 1998: Article 4). Japanese Government representatives from the Finance Ministry and Cabinet Office are legally permitted to attend central bank board meetings and 'express opinions' which can shift the course of monetary policy (Bank of Japan Act, 1998: Article 19). These are features that have existed since 1998 and contraindicate a 'central bank that is legally independent' (*pace* Monnet, 75). True, they have birthed pointedly heterodox policy, yet the exodus of fixed-income and foreign-exchange traders from Nihonbashi never happened. The Yen remains the third most traded currency and Japanese government bonds are good collateral worldwide. Investors appear to be punishing the not-really-independent Bank of Japan by continuing to patronise it.

Thinking through the implications of Monnet's analysis beyond the EU requires engaging proactively with similar institutional structures and market realities, which permit the direct balancing of monetary policy with electorally determined political aims without market collapse. Under such conditions, Monnet's 'great engine of state', the central bank as social insurer, might achieve its full promise.

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Moschella's book, *Unexpected Revolutionaries*, takes aim at perceptions of independent central banks as wholly technocratic institutions, responsive only to a narrow brand of economic thought and the animal spirits of private capital. Presenting a reputation-protecting account of central bank behaviour, Moschella argues that the 'unconventional' policies of the past two decades have been partially motivated by the need to create, protect, and sustain monetary authorities' reputation for effective economic management:

> Reputation protection led them to move away from well-established monetary practices only when political support for deviations was in place (i.e., when governments supported the central banks' unconventional actions) or when support was waning (as evidenced in public backlash), thereby requiring new policies to win back that support. (119)

This argument is supported by empirical analyses of the operations and communications of the US Federal Reserve System and the European Central Bank between 2008 and 2020. The empirical chapters focus on the sudden turn away from interest-rate setting by both institutions and the adoption of generous bank liquidity facilities and quantitative easing. The case studies reveal a remarkable degree of responsiveness of central bankers to political institutions. On both sides of the North Atlantic, monetary authorities initially held fast to interest-rate setting but abandoned that comfortable simplicity when faced with reputational damage and instead embraced the unconventional triad of excess liquidity, private-market guarantees, and public-debt purchase programmes. Moschella shows how compounding crises forced greater interaction between fiscal and monetary authorities and embraced expansive interpretations of their mandates as the general public fell out of love with 'hard money' rhetoric.

Moschella's objective is to show that central banks respond to markets, technical doctrine, *and politics*. Emphasising this additional factor is designed to problematise accounts of central banks as technocratic and primarily responsive to private-market constituencies. As she explains, 'central banks deviated from orthodoxy under specific conditions, in particular when governments directly or indirectly supported the use of unconventional monetary policies' (4).

Moschella's book makes a number of valuable contributions. It provides a systematic framework within which to understand why central bankers tell different stories about their institutional behaviour to different people at different times. Why, for example, did a team of Fed economists publicly propose 'money rains' by 'the Treasury financing a tax cut by issuing debt, and the Federal Reserve purchasing that debt' (Clouse et al., 2000) and then so forthrightly shift public attention away from fiscal-support of QE (Andolfatto and Li, 2013)? Moschella's book provides a fresh theoretical lens through which to make sense of such contradictory moves that is both informed by empirics and avoids collapsing into cynical notions of accumulation of power for its own sake. Approached in this way, the book teaches us how to understand central banks' justifications for their actions, rather than providing a causal account of the reason they adopt any particular policy. Moschella also provides a novel way of approaching the re-entanglement of monetary and fiscal

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power from 2008. Rather than collapsing the boundary between treasuries and central banks (Selgin, 2020), Moschella takes independence seriously while picking apart the technical empirics of fiscal-monetary coordination since 2008. Her rebuttal of the argument that central banks are 'the only game in town' is compelling.

The historical coverage of the Fed in chapters 3 and 4 could have been deeper, given the book's objectives. The period from 1913 to 1970 is covered extremely quickly and important research showing the Fed's intimate relationship with the Treasury is not cited – particularly Garbade's painstaking work in *Birth of a Market* (2012) and *After the Accord* (2021). The non-engagement with Greta Krippner's *Capitalising on Crisis* (2011) is another lost opportunity, especially as Krippner explores the dynamics of inflation and disinflation, including the techniques used to manage public-political perceptions, which are integral to the Moschella's arguments in chapters 3 and 4. Future engagement with this material could be used to test Moschella's theoretical framework longitudinally: is the brand of reputation protection she identifies unique to independent central banks, or did pre-1990 monetary authorities follow similar patterns when launching reflationary programmes?

Discussion of the pre-crisis 'conventional' status quo in chapters 2 and 3 might have been enriched by deeper engagement with major public choice and rational expectations arguments for the Fed's independence. Buchanan and Wagner (1977) and Sargent and Wallace's (1973; 1981) interventions were more direct than Lucas' (who is discussed) and provide vital intellectual context to the version of conservatism that Moschella invokes as the reputational lodestar (see also Sargent, 1982). The conception of monetary dominance which emerged was influential because it addressed the inter-temporal dilemmas of public-capital development from the vantage points of both politician and investor: thus speaking to both communities within Moschella's analysis. Sargent and Wallace's critique of monetarism also provided a rationale to implement inflation targeting without legal independence and thus an intellectual starting point for the version of economic conservatism upon which political actors built their idea of a credible central bank. It was so globally influential that Japanese central bankers cited that piece back to Fed economists when refusing to start outright public-debt purchases in 2000 (Fujiki et al., 2001). Faced with the deflationary dynamics of 2008–2009, one wonders whether those Riksbank Prize winners would have held firm against reflation via debt monetisation, or whether reputational considerations would have led them to disavow their life's work?

Moschella's Fed and European Central Bank (ECB) case studies leave open important lines of inquiry stemming from the contrasting features of the two regimes. The first is the relationship of monetary authority to fiscal constraint. The ECB's version of independence is legally and constitutionally integrated into a model of fiscal sustainability which knows no parallel in the US, where the only legal limit on debt-driven fiscal expansion is a legislative debt ceiling, susceptible to manipulation by the central bank (via yield-curve flattening) and amended by ordinary parliamentary vote. While a common attitude to deficit reduction had developed throughout the 1990s, money and public-debt constraints in the US and EU were fundamentally different as the sovereign debt crises and debt ceiling crises revealed. The other contrasting factor between the US and Eurozone is the absence/presence of a monetary policy veto player. The FOMC conducted its crisis-fighting policies safe in the knowledge that it could not be sued: the US federal courts held in 1929 that the New York Fed's open-market operations were largely non-justiciable (*Raichle v Federal Reserve Bank of New York*, 1929). Meanwhile, the ECB operated in a system with several judicial veto players, including the Court of Justice of the European Union and the German Federal Constitutional Court (*Gauweiler v Deutscher Bundestag,* 2015; *Weiss,* 2018; *Weiss v Bundesbank,* 2020). Both factors seem relevant to analysing the reputational calculation of both the Fed and the ECB. Intuitively, the different legal arrangements would have shaped the constitutional convulsions attending monetary-fiscal supporting measures in the Eurozone compared to the relative calm of the US between 2009 and 2013.

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Both books are particularly timely as advanced economies face the prospect of a monetary hegemon in which no major political party appears deeply committed to the orthodox version of depoliticised central bank independence. Throughout the Great Moderation, severance of electoral politics and monetary policy became oddly bipartisan across the North Atlantic. Those placid conditions allowed central bankers and their intellectual kin to define the terms on which the relationship between conscious political action and economic behaviour would occur. That consensus did not survive the tempest of the financial crisis, nor the waves of populism that followed in its wake. Moschella and Monnet provide scholars working on central banks specifically, and political economy generally, with a fresh and provocative set of ideas to help make sense of the new normal of politically-contested monetary policy.

Note

1. Hereafter quotations from Monnet's *Balance of Power* (2024) and Moschella's *Unexpected Revolutionaries* (2023) are indicated by page numbers in parentheses in the body of the text.

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