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From Political Economy ("PE") to Economics ("E") and Back?[1]

Some Thoughts on the Political Economy of Central Banking in Crisis and Post-Crisis Situations

It comes as no surprise that the topic *The Political Economy of Central Banking* in its broader context of the *Changing Role of Central Banks* as well as the ongoing European crisis can – and have to – be addressed from different perspectives. This issue contains a broad range of relevant aspects and is for sure a particularly difficult one: At the same time, it is extremely relevant, as many – if not all – of the „hot economic policy topics" discussed nowadays in the area of central banking and monetary policy are of an intrinsic „political economy nature". As a matter of fact this automatically gives rise to a number of quite controversial discussions.

What Does the "Political Economy of Central Banking" Mean?

Central bankers tend to have an automatic response when discussing Political Economy (PE) issues: "This is a question of central bank independence." Very likely, the first and only thought that comes to most economists' minds is that the political economy of central banking deals with central bank independence (only). Of course, there is some relevance in this approach. However, often and very quickly PE then is confused with „politics", in a way which is not really helpful to define and to deal with the right questions. PE in its fundamental sense is something quite distinct from politics, even though both areas are closely related (and intertwined). In addition, PE is not only different from politics, it is also a much broader concept than Economics (E) in the narrow sense this term is used and understood today (most of the time).

When James Stewart published his book on *The Principles of Political Economy* in 1767, it dealt mainly with questions like „how nations grow" and what can be done „to increase production". The "political" perspective in his approach was represented by an (economic) "policy" aspect on the one hand and an extensive institutional context on the other hand. Later on, starting with Alfred Marshall's famous „Principles" in 1890, this classical understanding of the term „Political Economy" was replaced by „Economics" in a very narrow, market-focussed interpretation. This dichotomy is perhaps best illustrated by the fact that institutional economics up to today has established itself as a mainly independent branch outside of economics, which concentrates on understanding evolutionary processes and the role of institutions in shaping economic behaviour and policy making.

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Contrary to this, independence from "politics" in the area of monetary policy has been concentrating on central bank independence since the early 1990s, based on the inflationary experience since the mid-1970s. For example Goodman (1992) argued that the historical empirical evidence of central banking – especially in Germany but also in France and Italy – illustrates the importance of the degree of central bank independence from the political authorities. He concluded that central bank independence leads to lower inflation outcomes. This road of research was followed and empirically explored by an increasing number of researchers – for example Alesina and Summers (1993) or Eijffinger and de Haan (1996). The results of this strand of literature had a significant impact on the modern "design" of central banks. That is why most economists would expect something along these lines under a headline

like *The Political Economy of Central Banking*. But there is still this widely neglected different approach of putting PE into a much broader classical context, which seems to have become forgotten in the historical transformation from PE to E. As many of the crisis-related questions and challenges central banks face today seem to be much more of this classical PE nature, it might make sense to concentrate a little bit more on this side of the coin is helpful.

The Need for a Return of (Classical) "Political Economy"

Historically, the roots of the discipline "political economy" trace back to the 18th century. The world's first professorship in political economy was established in 1754 at the University of Naples, where the Neapolitan philosopher Antonio Genovesi was the first tenured professor in PE. When talking about PE here in Vienna, one has to mention also that only some years later Joseph von Sonnenfels was appointed a PE chair at the University of Vienna in 1763. To underline the broad meaning of PE at that time, it makes sense to point out the Sonnenfels article *Ueber die Abschaffung der Tortur* (1775) that made him famous for bringing about the abolition of torture in Austria. This illustrates very well that PE has its roots in moral philosophy, which closes the circle to James Stewart and Adam Smith and their broad foundation of E in PE. And as late as in 1911, Josef Schumpeter in his *Theory of Economic Development* used the term „systems of political economy" based on „certain principles". In short, PE was developed as the study of the economies of states or nations, hence the term political economy.

Substantially, in this transformation from PE to E a specific focus on historical processes or determinants as well as on institutional settings, change and adjustment was lost. These issues only "survived" outside „Economics" as a rather distinct discipline and up to today there is no clear paradigm or widely accepted understanding what the exact meaning and role of PE is in our existing modern market-based economy. However, one should not forget, that PE and E simply represent two different perspectives on the same set of economic issues or on the same historical developments – and very likely if not for sure – these both perspectives are important at the same time!

Taking political economy seriously in a modern context, PE contemporarily deals with the interplay between economics, law and politics, trying to analyse and to understand how public policy is created and implemented. In a very recent contribution explicitly using the term PE on the *Political Economy of the Euro*, Paul de Grauwe (2013) criticises the founding fathers of the European Monetary Union for not having understood the necessary economic conditions for a successful monetary union and for not recognising the inherent fragility of the monetary union they established. It is this broader approach of the term "political economy" that may help better understand some of the recent problems we face and which may help to overcome some of the mistakes of the past and to improve the situation for the future.

Relating this perspective to central banking, important elements of this view are to qualify central banks as (historically grown) institutions and to understand that central banking is not an end in itself. Central banks are specialized institutions that serve societies' interests based on delegated functions and tasks, including central bank independence as a particular design element based on historical experience. However, these interests are not set in stone. They might change over time, especially if economic crises shake common wisdom of how to make (macroeconomic) policy or new views concerning the adequate institutional setting gain ground. Consequently, it seems natural that also the objectives of monetary policy and/or the range of central bank functions may change.

The "Great Moderation" as the Golden Age of Central Banking?

During the closing decades of the 20th century a consensus about the institutional design of central banks had emerged. Central banking was largely characterised by one instrument (a short-term policy interest rate) and one target (an inflation objective) assigned to an independent body. Moreover, the so called "divine coincidence" implied that "even if policymakers cared very much about activity, the best they could do was to maintain stable inflation" (Blanchard et al., 2010). As long as inflation was low and stable, the output gap was likely to be small. However, the economic and financial crisis that started in 2007 taught us that imbalances can build up underneath the calm macroeconomic surface of the Great Moderation (Bernanke, 2004) leading to financial vulnerabilities and ultimately to a kind of unexpected severe financial crisis, which transmitted itself globally as well as to the real economy. We had to recognise that the achievement of price stability does not guarantee financial stability and the avoidance of all the negative consequences of a financial crash. This triggered substantial innovations in the overall institutional design of the European Union.

Some of the currently most relevant aspects of the PE challenges for central banking are related to a forthcoming new institutional structure of banking supervision as well as the newly introduced macroprudential regulation and oversight structure. Before the present crisis, the responsible institutions for banking supervision in the euro area differed considerably from country to country. In the late 1990s, however, there was a trend for financial supervision outside central banks. Very often these institutions were in charge of supervising banks, insurance companies and securities markets. However, the lessons from the crisis seems to have reversed this trend, as recent reforms in the USA and Europe show. Today, most European central banks are banking supervisors at least to some degree.

In addition, the European Union is creating a banking union, in which an important building block is the Single Supervisory Mechanism (SSM) giving supervisory powers of a European dimension to the central banking system. The SSM's task is to build one system of European supervision with the European Central Bank (ECB) at its centre, given the final responsibility for supervision over all banks in the participating countries, with a special focus on big banks of a systemic nature and on cross-border banking. Therefore, even if the ECB will not be able to directly supervise all the existing banks, the more systemically important banks will be subject to that direct supervision on a continuous basis.

This is the European answer to one of the weaknesses of the economic system unveiled by the crisis. However, with each answer to a specific question, new and perhaps more difficult questions pop up. Considerably deviating from the "before-crisis"-mainstream consensus, the ECB will be entrusted with additional functions and objectives to be tackled, and direct banking supervision is one example only of the increasing number of responsibilities which are formally or informally seen with central banks now. However, in accordance with the rule that there should be as many instruments as targets, the ECB will also be equipped with an extensive set of micro- and macroprudential powers. Hence, the well-known issue of the link between different policies and whether there are trade-offs between policy-areas has returned. It was only temporarily hidden by the "Great Moderation" when everything looked fine almost automatically. The future will tell, whether a central bank responsible for several functions (i) will find it harder to achieve the primary objective of price stability, (ii) will be able to maintain its high level of credibility, (iii) will be successful in establishing financial stability although there is no commonly agreed definition of it and (iv) will face policy conflicts between price and financial stability; to name but a few of the challenges that will arise.

A Changing Landscape for Policy Making

While the new situation will be challenging, it also bears the potential of great success. In the future, the assessment of the macroeconomic situation in the Eurosystem can be based also on data and analysis conducted as part of banking supervision, thereby providing much more information on monetary policy counterparties and their behaviour. Hence, monetary policy decisions can be taken on grounds of more and better information. Moreover, monetary policy will focus on price stability and prudential policy will focus on financial stability. The objectives are assigned to different bodies within the ECB. The supervisory branch will have a clear incentive to intensify the prudential policies seeking to counteract emerging financial imbalances and financial risks. This will in turn reduce the likelihood of crises and therefore lender-of-last-resort interventions. Consequently, there are not necessarily policy conflicts – the policy areas can also complement each other well.

The crisis has brought to light not only banks are prone to (bank) runs, but also sovereigns with high debt levels face the risk of (bond market) runs. The existence of a bad equilibrium, in which a high debt level calls the sustainability of government finances into question, which in turn leads investors to turn away from this country, increasing the country's refinancing costs and finally indeed making public finance unsustainable, became evident in some European countries in summer 2012. A very high interest rate can make even a low level of debt unsustainable and consequently be self-fulfilling.

In principle, central banks can reduce the probability of a bad equilibrium by providing liquidity to the government if needed. However, this lender-of-last-resort function for governments raises the risk of moral hazard. Governments would face a reduced incentive to press ahead with their consolidation efforts necessary to reduce the debt burden. This line of argumentation will ultimately lead to a kind of unwarranted fiscal dominance, which – from a monetary policy perspective – has to be avoided. It risks sizeable costs in the case of high and uncontrollable inflation rates.

As most governments in advanced economies face elevated debt levels, financial markets are pressing for consolidation, which puts their countercyclical policy role – if not their overall fiscal function – into a narrow corset. Consequently, the room of manoeuvre for fiscal policy is very likely to be small also in the years to come. Hence, a significant policy issue is the adequate speed and size of fiscal consolidation: A speed which does not lose sight of the medium term objective of bringing down government debt levels, but leaves enough scope to support growth when necessary.

Easy to understand that all these challenges are of a very institutional and, therefore, political economy nature. In a nutshell: PE deals with the question, how social institutions, the political environment and the economic system interact and how they influence each other. And one may come to the conclusion that this perspective got somehow lost in the economic development before the current crisis. However, it would have been especially important for a better understanding what happened during this phase of a crisis unfolding and it will be essential for an unwinding of the institutional challenges which are still ahead of us.

Blanchard et al. (2013) rightly remark that "the contours of a new macroeconomic policy consensus remain unclear". Will the objectives of price stability and financial stability indeed reinforce each other? Will macroprudential policy tools work as currently expected? Will the new institutional setup contribute to a more stable environment? Indeed, there are many open questions of how macroeconomic policy will look like in the future. At the same time it seems to be very clear that the relevant issues cannot be addressed by pure "E" considerations. What we will need is definitely an approach including many important elements of "PE", even if we seem to be at the very beginning only on how to make use of these. These are exciting times.

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