Introduction

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The Great Financial Crisis of 2007–2008, like the Great Depression of the 1930s, focused the American public's attention – and ire – not just on Wall Street, but also on the Federal Reserve (the Fed) – the US central bank. In normal times, the Fed operates under the radar, generating intense interest from investors, and mostly yawns from everyone else. But at times of financial crisis, like 1929, or 2007–2008, or even 1979 when the Fed raised interest rates sky high, piercing scrutiny and conflict breaks out regarding the Fed's policy. Indeed, at times like that, more than just this or that policy is up for grabs. The Fed's whole institutional structure and its very *raison d'être* comes under attack. Why did the Fed let the economy crash? Why did it raise interest rates so high? Why did it bail out Wall Street while leaving 'main street' high and dry? Who benefits from the Fed's policies? Who really pulls the strings there? Do we even need a Federal Reserve?

Perhaps surprisingly, until fairly recently, these questions of 'why', 'who benefits' and 'who pulls the strings' were mostly ignored by economists and political scientists even though the public periodically demanded to know the answers.¹ For decades after the Second World War, most economists simply *assumed* the answers: the Federal Reserve was operating in the 'public interest'. Standard theory implicitly claimed that trained technocrats at the Fed were trying to make the optimal policy for the economy and everyone in it. If they failed to do so, it was not out of malice or because they were trying to do something else: it was simply because they made a mistake.

But as Jane D'Arista and William Greider brilliantly argued in their crucial books more than three decades ago, this benign intellectual consensus is something new. Rather, in the late nineteenth century, prior to the founding of the Fed in 1913 and all the way up to the time of the New Deal, scrutiny and critical analysis of plans for a central bank and then of the Federal Reserve itself were front and center in American politics (D'Arista, 1994; Greider, 1987). As Greider reminds us, this *money question* – the issue of who controls the financial system and who wins and who loses as a result – has been central to American politics, and indeed politics in many other parts of the world, for centuries. In the United States, as in other places, workers and especially farmers, highly dependent on bank credit to finance their agriculture, were intensely interested in the factors affecting the cost and availability of credit. These factors included the monetary standard (gold, silver, paper money) and who controlled the banks, including the central bank. As a result, when the question of creating a central bank came up in the US, farmers and workers and intellectuals naturally raised the same issues: who is running the bank? To what end? To help the farmers (debtors) or to enrich the bankers (the creditors)?

For their part, the bankers themselves were also very interested in these distributional and power questions. They wanted to make sure that they – and they alone – had a firm hand on the monetary spigot so that high and unexpected inflation would not destroy their wealth. William Jennings Bryant's famous anti-banker speech at the 1896 Democratic Convention

against the gold standard in which he exclaimed: ‘you shall not crucify mankind upon a cross of gold’ is one of the more memorable manifestations of this conflict over the control of money and credit. The ‘money question’ illustrates this truth: class conflict over the control of the monetary standard is inherent in the very nature of central banking.

But the ‘Neo-Keynesian’ mainstream macroeconomics of the 1950s to 2000s would have none of it. Central banks, according to this perspective, are the guardians of the national interest. Class conflict has nothing to do with it.² I should note that this view is deeply ironic. For John Maynard Keynes – the supposed inspiration of the Neo-Keynesian consensus macroeconomics – was himself acutely aware of the class nature of central bank policy, which he strenuously criticized and fought against (Crotty, 2017, Chapter 12).

For example, James Tobin, a brilliant economist and leader of the neo-Keynesian revolution, had a blind spot on this issue. Despite occasionally being highly critical of the Fed’s high interest monetary policy, he refused to examine deeply the political roots of these policies. This selection from his essay on Monetary Policy (posthumously published) is characteristic (Tobin, 2018):

Paul Volcker, while chairman of the Board of Governors of the Federal Reserve System (1979–1987), was often called the second most powerful person in the United States. Volcker and company triggered the ‘double-dip’ recessions of 1980 and 1981–1982, vanquishing the double-digit inflation of 1979–1980 and bringing the unemployment rate into double digits for the first time since 1940. Volcker then declared victory over inflation and piloted the economy through its long 1980s recovery, bringing unemployment below 5.5 percent, half a point lower than in the 1978–1979 boom. Volcker was powerful because he was making monetary policy. His predecessors were powerful too. At least five of the previous eight postwar recessions can be attributed to their anti-inflationary policies. Likewise, Alan Greenspan’s Federal Reserve bears the main responsibility for the 1990–1991 and 2001 recessions. Central banks are powerful everywhere, although few are as independent of their governments as the Fed is of Congress and the White House. Central bank actions are the most important government policies affecting economic activity from quarter to quarter or year to year...

Tobin chose not to delve more deeply into an analysis of the source of these problematic monetary policies other than to note: ‘Priorities reflect national dreams and nightmares...’ (Tobin, 2018).

Yet, despite the lack of attention to the role of class conflict, there was one element of conflict that mainstream economists highlighted in their analysis of central banking: the perceived danger that politicians and government officials would try to capture control of the central bank to pursue their own short-term or even corrupt goals. Although this concern did not lead to deep analysis by economists of the underlying forces driving central bank policy, it did lead to one simple recipe: keep central banks ‘independent’ from politics. *Central Bank Independence* became the mantra of mainstream economists as a necessary step to make sure that neutral central bank technicians would operate in the public interest. But what the term ‘central bank independence’ really means, and the ambiguities and complexities involved in the concept, were mostly left undiscussed (see Chapter 4 in this volume).

A first major post-war crack in this mainstream economics view came in 1979, when newly appointed Federal Reserve chair, Paul Volcker, jacked up interest rates into double digits in an attempt to slay inflation – at any cost (see Chapters 1 and 2 in this volume). A major recession followed; farm foreclosures skyrocketed; families lost their homes and factories closed. Protests against Volcker and the Fed spread and, for the first time in decades, ‘The Money

Question' came to the fore. William Greider's book, chronicling and explaining the historical roots of this event, became a best seller (Greider, 1987).

My essays, written over the span of almost forty years and collected here, were initially motivated by my attempt to understand the forces driving Paul Volcker's monetary policy and to frame and answer the *money questions* about the Federal Reserve.

The early essays focus on the Federal Reserve. I soon broadened my field of study and began exploring the similarities and differences between the factors driving the Fed's policies, and those determining the policies of central banks elsewhere. As is often the case, by using a comparative approach and expanding the scope to other countries and times, I was better able to understand the underlying factors that can explain central bank policy and how these policies can change over time.

Through this process I and my co-author, Juliet Schor, developed a 'contested terrain' approach to understanding central bank policy (see Chapters 8 and 9 in this volume).³ I came to understand that central banks, like other government institutions, are a battleground for control fought by different economic, social and political forces. The victors of this battle are not always the same. They depend on the 'constellation' of political forces, historical accidents, institutions and the evolution of the economy at different times and places. The history of the Federal Reserve illustrates this point. At its inception in 1913, the Fed was dominated by the major banks, in large cities like Chicago and especially New York. This domination, however, led to fateful monetary policy choices that significantly contributed to the Great Depression (see Chapter 6 in this volume). As a result, the Roosevelt administration reformed the structure of the Fed to reduce the direct control by the banks and enhance the control of the Federal Government. With the outbreak of the Second World War and the needs of war finance, the Fed was brought under even closer control by the government. However, by the 1950s, the Fed, with the help of the bankers, fought back against government control and little by little regained more independence from the government, increasing the sway of bankers in Federal Reserve policy (see Chapter 5 in this volume). This finance dominance of the Fed eventually led to the draconian monetary policy of the Volcker Fed in the 1980s and likewise contributed to the financial de-regulatory policies that led to the Great Financial Crisis of 2007–2008. And this economic crisis and the failure of the Obama administration's banker friendly bail-out policies contributed to the election of Donald Trump (see Chapter 3 in this volume).

This brief history of the political economy of the Federal Reserve helps to explain the title of this book of essays: *The Political Economy of Central Banking: Contested Control and the Power of Finance*. The central bank is a *contested terrain*. But the contest is not held on a level playing field. For a number of important structural and institutional reasons elucidated in this volume, bankers – and finance more generally – have great advantages when it comes to influencing the monetary, financial and regulatory policies of central banks. Typically, finance controls central banks. But – and this is crucial – the control is not definitive, it is contested by other groups and classes.

Finance is often able to be in control because it has significant advantages in the contest. These advantages include technical knowledge about how financial markets work, and the ability to create revolving doors so that central bankers can get lucrative jobs after their stints at the central bank. Moreover, finance has a big incentive to play this game because of the large potential costs and benefits they can get depending on what the central bank does. In turn, the central bank needs the bankers: they need them to act as channels through which they

conduct monetary and credit policy; and they need them to help defend the central bank against political attack. Finally, the central banks have the means – policy tools – such as interest rate policies and regulations, that offer carrots and sticks to banks. Hence there is an ‘I’ll scratch your back, you scratch mine’ symbiosis between finance and the central bank that can have a huge impact on monetary and regulatory policy, and therefore on all of us.

This last point illustrates that there is no such thing as ‘central bank independence’, a concept so important to economists and politicians. Instead, by necessity, central banks operate in a political environment. They need allies and support to give them the bureaucratic and political space they need to conduct their policies. To get this insulation from the government and from ‘the masses’ central banks often rely on the key support of private banks. Far from promoting independence, this dynamic increases the central bank’s *dependence* on finance (see Chapters 4 and 8 in this volume).

The crisis of 2007–2008 has called the central banks’ autonomy into question once again. Ron Paul’s best-selling book *End The Fed* (Paul, 2009), illustrates this wave of dissatisfaction. Donald Trump rode the wave of an anti-banker platform into the White House.⁴ Since being elected Trump has again bolstered the power of the banks. But the Fed is now weakened, making it vulnerable to attacks from Trump should he decide to go on the offensive.

Understanding that the central bank is a contested terrain, and that central bank structures and policies have changed over time and across space, opens up the possibility of transforming central banks, so that they make policy in the interests of a broad segment of society, and not just in the interests of finance or other elites. The last essay in *Contested Control* outlines a set of institutional reforms of the Federal Reserve to make it more accountable and democratic so that it will make policy in the interests of the broader society.

The structure of *Contested Control*

Many of these essays were written with co-authors, a group of very talented individuals, to whom I have a great debt for their contributions.⁵

Some of these essays have been published in academic journals; others in edited books; some of the essays are published in this volume for the first time. The justification for publishing these essays together in one place, even though a number of them have been published before, is several-fold. First, many of the essays have been published in hard to find, even out of print, journals and books. In addition, the essays build up a cumulative understanding of the political economy of central banks, across different countries, and over time, spanning the 1980s to the period following the great financial crisis (GFC). Together, they illustrate the structures and forces that affect central bank policy, and lay out alternative visions of what a more democratic and inclusive central bank structure and policy can look like. In addition, the selection of essays illustrates that a variety of analytical methods – historical, institutional, economic modelling and econometrics – can be valuably used together to understand the political economy of central banking. To emphasize these points, the essays in this book are presented in thematic, not chronological order.

The first three essays (in Part I) serve as an introduction to the issues raised here by focusing on macroeconomic policy in two dramatic cases: the Volcker years at the Federal Reserve and then the (proposed) policies of Donald Trump. These historical essays span the time range of the book: from the founding of the Federal Reserve (Chapter 1) to the Volcker interest rate hikes (Chapter 2) to the election of Donald Trump (Chapter 3). The chapter on Trumponomics

(Chapter 3) illustrates how things can go very wrong if central bank policy is as misguided as it was under the reign of Alan Greenspan in the 1990s and 2000s.

Part II takes a more analytical and empirical approach, starting with an analysis of the Federal Reserve. The section develops the underlying idea of the *contested terrain* approach to central banking (Chapter 4). Next it provides historical evidence for this approach by looking at the famous Federal Reserve–Treasury Accord of 1951 through the perspective of this approach (Chapter 5) and Federal Reserve Policy during the Great Depression (Chapter 6). Chapter 7 presents econometric evidence showing that the Federal Reserve makes policy with a focus on promoting corporate profits as suggested by the approach developed here.

Part III broadens the analysis to comparative central banking, looking not only at the Fed, but also at other central banks around the world. This section starts out with an updated, succinct statement of contested terrain theory of central banking⁶ (Chapter 8). Chapter 9 utilizes this approach to study macroeconomic policy in the US and Western Europe in the rise of the so-called ‘Golden Age’ economies of post-Second World War capitalism. Chapters 10 and 11 then present a mathematical model and econometric analysis which applies this approach to a comparative study of central banks. Chapter 12 extends the model of Chapters 8 and 9 to analyse how the nature of the exchange rate regime impacts the political coalitions determining central bank policy and how these coalitions, in turn, affect the choice of exchange rate regime. Chapter 13 presents additional empirical analysis of the impact of central bank policy on financial incomes in a range of OECD countries showing that restrictive monetary policy redistributes income to bankers and financiers and away from workers and farmers.

Part IV shifts from an analytical focus on the forces driving central bank policy, to an assessment of policy approaches that have characterized central banks in different contexts. This section focuses on central bank policies primarily in developing countries and emphasizes the experiences there with central banks that have taken an expansive view of their role in promoting economic development. This ‘developmental approach’ is in contrast to ‘inflation targeting’, the more recent dominant approach to central banking that focuses almost exclusively on limiting inflation while ignoring employment and financial stability.

This section chronicles the rise of ‘inflation targeting’ as a dominant prescription for central bank policy, and shows how this prescription is an elixir for bankers, but hard to swallow for the rest of society (Chapter 14). Inflation targeting focuses on keeping inflation at a very low level, while ignoring economic growth, unemployment and financial instability. This policy framework contrasts with what I call ‘developmental central banking’ which has a long history in both developing and the now developed countries. Developmental central banking broadens the mandate of central banks to focus on economic development for the country as a whole. Chapters 15, 16 and 17 describe experiences with developmental central banking and discuss conditions under which this makes for a better approach than inflation targeting as an operating structure for central banks.

Part V returns to a discussion of the great financial crisis of 2007–2008. Following the crisis, the major central banks – the Fed, the Bank of England (BOE) and the European Central Bank (ECB) – spent billions of dollars bailing out financial institutions and then implemented an aggressive monetary policy, commonly called Quantitative Easing (QE), to fight against financial collapse and to try to turn the economies of the US, UK and Europe around.

These previously unpublished papers focus on the political economy of the Federal Reserve’s QE policy from several different perspectives. Chapter 18 analyses the impact of

QE on bank profits specifically. Did QE help the banks? Which banks? Evidence that QE helped the banks would lend support to the *Contested Control* perspective on central banking. Chapter 19 broadens the perspective beyond banks to look at the impact of QE on various industries. It provides an empirical analysis to assess whether QE helped to restore profitability of various industries. It asks: Which ones? How long did these benefits last? The chapter shows that a broader group of industries than only banks were assisted by QE. Finally, Chapter 20 estimates the overall impact of QE on income distribution in the US. QE has been very controversial and has been accused of helping only wealthy investors while hurting the rest of the population. This accusation is an example of the heightened conflict over Fed policy in the wake of the crisis as I described earlier. Chapter 20 reports on a careful empirical analysis to address this question. The essay shows that while Fed policy did help generate some employment and reduce mortgage costs for workers and middle-income households, most of the benefits went to the wealthier members of society who hold financial assets. This is because QE raised the value of financial assets significantly. This assessment of the distributional affects of Federal Reserve policy following the crisis thus provides more evidence for the *Contested Control* perspective on Federal Reserve policy.

As a whole, these papers suggest that the major beneficiaries of Fed policy following the crisis were those at the higher ends of the income distribution, the bankers and shareholders in a few other industries. The bulk of the population, as of 2016, benefited much less if at all. These findings are consistent with the perspective that, under the current Fed structure, it is primarily the banks and the wealthy who benefit from Fed policy.

The question then is this: can the Federal Reserve be reformed to be more accountable and responsive to a broad segment of society? Part VI presents the case for *democratizing* the Federal Reserve as a way to achieve this goal. Chapter 21 is Congressional Testimony I presented during the Volcker era which critiques Federal Reserve policy and lays out a rationale and vision of a more democratic and accountable Federal Reserve.

Chapter 22 illustrates that even among progressive economists, there is no agreement on how to reform the Federal Reserve and on what difference it would make. This chapter presents a debate between me and my colleague Robert Pollin on the desirability and efficacy of *democratizing* the Federal Reserve.

Chapter 23, the final essay in the book, explores more fully the arguments for making the Federal Reserve democratically accountable and transparent and explores various models of Federal Reserve accountability. In this chapter I also respond to possible objections to democratizing the Federal Reserve, including the claim that it will lead to cronyism, corruption and irresponsible governance of the Fed. A new essay, written for this volume, this chapter attempts to address challenges to the concept of democratizing the Fed when one is confronted with an autocratic and corrupt President supported by an enabling legislature.

Overall, *Contested Control* argues that the question of why do central banks do what they do is important; that assessing the role of political and economic power in determining these outcomes must be central to an analysis of central banking; that the tools of history, political science, economics and statistics are useful for answering these questions; and that, finally, alternative structures, including those that render central banking more transparent, accountable and democratic are preferable and possible. But, as a contested terrain, they will never be achieved without political struggle.

Notes

1. In the last few years, by contrast, there have been several books that address these questions: see, for example, Adolph (2013), Binder and Spindel (2017), Conti-Brown (2016), Dickens (2018) and Jacobs and King (2016).
2. See, for example, Samuelson and Solow (1960).
3. We borrowed this term from Richard Edwards' classic book about labor relations in American capitalism (1979).
4. Of course, Trump's victory was due to many other factors as well: his ability to manipulate and exploit racial, religious and gender resentment being, perhaps, the most important.
5. I greatly appreciate the contributions of my co-authors (in alphabetical order): Thomas Ferguson, Arjun Jayadev, Juan Antonio Montecino and Juliet Schor.
6. This book modifies the term 'contested terrain' to 'contested control' to reflect the fact that in the current period, finance is in control of most central banks, but this control is nonetheless still contested.

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