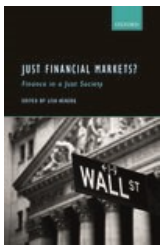

Just Financial Markets? Finance in a Just Society

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CHAPTER

10 Normative dimensions of central banking: How the guardians of financial markets affect justice

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Abstract

Monetary policy, and the response it elicits from financial markets, raises normative questions. This chapter, building on an introductory section on the objectives and instruments of monetary policy, analyzes two such questions. First, it assesses the impact of monetary policy on inequality and argues that the unconventional policies adopted in the wake of the financial crisis exacerbate inequalities in income and wealth. Depending on the theory of justice one holds, this impact is problematic. Should monetary policy be sensitive to inequalities and, if so, how? Second, the chapter argues that the leverage that financial markets have today over the monetary policy agenda undermines democratic legitimacy.

Keywords: monetary policy, justice, inequality, democratic legitimacy, financial markets as a filter

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10.1 Introduction

It is a constitutive feature of central banks to play an interface role between governments and financial markets (Singleton 2010, 4ff.). They set monetary policy on behalf of the government, provide banking services to the latter, and often play a role in managing the public debt; at the same time they act as a bank for commercial banks, serve as a clearing house for the balances of the private banking sector, and have important supervisory functions in the banking sector. Given this role of central banks as one of the principal guardians of financial markets, any account of just financial markets naturally includes subjecting the role and actions of central banks to normative scrutiny.

Two roles of central banks should be distinguished in this context. First, the role of central banks as regulators—or macroprudential policy-makers, in today's terminology—who are charged with promoting

financial stability, that is, reducing the risk of financial crises; and, second, the central bank's task of ensuring price stability in the economy, that is, monetary policy more narrowly defined. The exercise of both of these functions is intertwined with the functioning of financial markets and both of these aspects of central bank activity raise normative questions. Even though it is impossible to disentangle the two roles entirely, this chapter will focus on the second aspect.

Monetary policy has moved off the radar of normative discussion in recent decades.[1] Normative scrutiny has focused on the other pillar of macroeconomic policy, fiscal policy. Institutionally, this situation is reflected
p. 232 in the ↳ doctrine of central bank independence. Monetary policy has come to be perceived as a technocratic exercise that is best left to a group of experts, whose mandate might be formulated by politicians, but who operate at arm's length from the latter.

In light of the events since the onset of the financial crisis in 2008, it seems no longer appropriate to exempt monetary policy from normative scrutiny in this way. With the room for manoeuvre in fiscal policy heavily constricted due to both external constraints such as tax competition for capital (e.g. Dietsch 2015, Dietsch and Rixen 2014) and the self-imposed policy of austerity to contain the further growth of public debt (Blyth 2013), monetary policy has become the prime tool of macroeconomic policy today. This is a source for concern for prudential as well as for broader, normative reasons. While it might have been plausible to argue in the pre-crisis world that monetary policy was relatively benign in its impact on the distribution of income and wealth as well as from a perspective of democratic self-determination, this is arguably no longer true for the unconventional monetary policies employed in recent years. In addition, as for instance the minutes of Federal Reserve Board meetings in 2008 reveal, there is significant theoretical and practical uncertainty about both the effectiveness of unconventional policies and their impact on other social objectives.

In particular, we can distinguish three normative dimensions of monetary policy. First, the distributive dimension: does monetary policy have a significant impact on the distribution of income and wealth and, if so, how should this impact influence policy-making? Second, the democratic dimension: when tensions arise between the monetary policy that best serves the economic interests of the citizens living in the currency area in question on the one hand, and the monetary policy that is optimal considering the response of global financial markets on the other, how should we arbitrate tensions of this kind? Third, the cross-border dimension: when the monetary policy of one country, via international capital flows, has an impact on people elsewhere, should central banks take this impact into account in their policy-making and, if so, how?

This chapter concentrates on the first two of these dimensions.[2] While the third dimension is by no means less relevant today—as demonstrated for instance by the capital outflow from emerging markets in reaction to the discussion of "tapering" of asset-purchases by the Federal Reserve in 2013 (Wigglesworth et al. 2013) —the international issues raised by monetary policy are distinct from domestic ones.

The chapter is structured as follows. I start off in Section 10.2 with a primer on monetary policy for those
p. 233 unfamiliar with it, setting out its goals as well as ↳ the means employed to pursue these goals. This preliminary section fills in the empirical and conceptual premises that my subsequent argument will rely on. I then discuss the distributive dimension of monetary policy (Section 10.3). This section is divided into first the factual question of how monetary policy impacts inequality, which then feeds into the normative and institutional questions of how we should respond to this impact. Finally, Section 10.4 of the chapter addresses a tension between monetary policy and democratic legitimacy.

10.2 Ends and means of monetary policy

What are the primary objectives of monetary policy? Phrased in economic jargon, what should be the objective function of the central bank? Governments delegate some aspects of the social welfare function they pursue to central banks. They formulate the objective function in the mandate they hand to central banks. But what exactly does this mean in practice? What are the concrete social objectives that economic welfare can be broken down into in the context of monetary policy? We need to be clear on how the objective function is defined in modern monetary theory before we can ask whether it should include other social objectives and, if so, how.

For many, the first goal of monetary policy that comes to mind is price stability, which means promoting low inflation while avoiding deflation. Why is low inflation a goal worth pursuing? Several reasons can be invoked here.[3] First, since inflation effectively represents a tax on nominal assets—that is, assets that are not indexed to inflation—it creates distortionary effects; people will hold less nominal assets than they would in a situation without inflation. Second, inflation is bad because it creates uncertainty. Especially at higher rates of inflation, which have historically tended to be subject to bigger fluctuations, economic agents will be uncertain about the future value of money. This complicates their decision-making and may, for example, discourage them from making long-term investments. Third, even when abstracting from uncertainty, inflation creates relative price dispersion; given that people enter economic contracts with variable durations, only some of them will be able to adjust their contracts when inflationary expectations change. Those who cannot will be stuck with inefficient prices for the duration of their contract.

Conversely, monetary policy aims to avoid deflation, because it creates distortionary effects in the opposite
p. 234 direction. When money gains in value ↳ compared to other assets, people have an incentive to hold cash rather than to invest or consume.[4] This has a negative impact on economic growth.[5]

Price stability is the first and often the only item in the mandate of central banks. A second item, the promotion of employment, is an explicit objective only in some countries. The US is the most prominent example. The ECB, despite its reputation of focusing exclusively on price stability, is also required by Art. 127(1) of the Treaty on the Functioning of the European Union to "support the general policies in the Union"—including the promotion of employment—provided that there is no "prejudice to the objective of price stability." In general, even where employment does not figure in their list of competences, central bankers know that neglecting high rates of unemployment might lead to a change in their mandate.

Finally, financial stability is the third task of central banks.[6] They are supposed to help commercial banks overcome liquidity bottlenecks due to maturity transformation,[7] to ensure that banks do not take excessive financial risks, and to identify and prevent potential asset price bubbles. This third goal of monetary policy has taken center stage since the onset of the financial crisis; the ECB, for instance, has acquired formal responsibility for aspects of financial stability (Fontan 2013).[8]

In sum, I think it is fair to say that price stability, employment, and financial stability are perceived to be the main objectives of monetary policy today, with price stability as the *primus inter pares*. How do central banks pursue these three objectives?

Central banks have two principal, and interconnected, policy instruments at their disposal.[9] They set interest rates and they conduct open-market operations (OMOs). We need to distinguish two kinds of interest rates. First and most importantly, central banks set a target for the *money market rate* (or federal funds rate in the United States) at which banks and other financial institutions lend funds to each other. The
p. 235 central bank then uses open-market ↳ operations, that is, the buying and selling of short-term government bonds, to influence this interbank interest rate.[10] Second, central banks set the *discount rate* (or the rate for the marginal lending facility as the ECB calls it), that is, the interest rate at which banks can

borrow money from the central bank. Short-term loans from the central bank notably form part of commercial banks' strategy to meet their reserve requirements.

Quantitative easing, which refers to the unconventional monetary policy employed in response to the financial crisis, differs from what happens in normal times in the following ways. The first distinguishing feature is the duration and permanent *versus* temporary character of the OMOs deployed. In normal times, OMOs involve the buying or selling of short-term government bonds and are temporary in that they involve repurchase agreements. Since the financial crisis, OMOs have targeted longer-term government bonds,[11] their repurchase agreements have covered longer and longer time-spans,[12] and/or they have dropped the repurchase agreement from the contract altogether. It is the latter permanent OMOs or outright purchases of securities that has led to a ballooning of central bank balance sheets since the crisis.[13] In some cases of quantitative easing, a second difference to normal times lies in the asset classes of securities that are bought and sold in the OMOs. Especially when the goal of the central bank is to repair banks' balance sheets, its quantitative easing programme is likely to target assets that have turned sour such as mortgage-backed securities.[14]

Before turning to the question of how monetary policy impacts inequalities in income and wealth, three remarks are in order on the effectiveness of central bank policy in achieving the above objectives. First, in normal times, the leverage of central bank policy over the money market has arguably declined in recent years. Why? Growing Repo and Eurodollar markets give commercial banks alternative ways to meet their reserve requirements. As Mehrling (2011, 25) argues, the fact that central banks are only a small player in those markets means that their capacity to tighten or loosen credit availability has declined over time.

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Second, the issue of how effective monetary policy is at promoting employment has always been controversial. Optimists maintain that lowering interest rates will translate into private investment, which in turn will promote employment. By contrast, economists who believe that private investment is largely exogenously determined question this link. First and foremost, John Maynard Keynes argued that when economies find themselves in a so-called "liquidity trap," lowering interest rates will not trigger private investment but merely induce agents to hold more cash (Keynes 2007 [1936], chap. 13).

Third, in order to assess how well a central bank is doing at promoting financial stability, it is crucial to distinguish between liquidity crises and solvency crises. By the former, we refer to a situation in which a bank is unable to meet its current obligations due to the maturity transformation between its assets and liabilities. By the latter, we mean a situation where the assets have lost so much value that this puts in jeopardy the meeting of liabilities as such—independently of the term structure. While an expansionary monetary policy of the kind we have seen since 2008 can be an effective tool for stemming a liquidity crisis, it is less certain whether it is an effective tool for combating solvency issues. One successful model for the latter is the Sveriges Riksbank's response to the financial crisis in Sweden in the 1990s, when all banks were nationalized. Following an analysis of their balance sheets, those with liquidity problems received funds to meet their liabilities, while those with solvency problems were wound down (Englund 1999).

These questions of effectiveness will take center stage when weighing different policy objectives against each other.

10.3 Monetary policy and inequality

With the nuts and bolts of monetary policy laid out, we can now pass on to the analysis of monetary policy through the lens of justice. The present section will focus on the impact of monetary policy on inequalities in income and wealth, whereas Section 10.4 will probe the democratic legitimacy of monetary policy.

In both cases, it is crucial to keep in mind that monetary policy is always mediated through the reaction of financial markets to the actions of central banks. It is the *combination* of monetary policy and the reaction by financial markets to it that generate consequences that might concern us from the viewpoint of justice. Different market reactions to the same monetary policy might lead to a more or less unequal outcome or to one that is more or less in line with democratic preferences in the monetary zone in question. Thus, the questions raised here are inherently linked to the regulation of domestic and international financial markets, which circumscribes the set of possible reactions available to financial markets in response to monetary policy.

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10.3.1 The factual question

Does monetary policy have implications for inequalities in income and wealth and, if so, what does this empirical link look like? The literature concerned with this question has distinguished a number of different channels or transmission mechanisms through which monetary policy affects inequalities.[15] Some of these suggest that expansionary monetary policy will tend to exacerbate inequalities. For example, since people's primary sources of income differ, expansionary monetary policy interventions that raise profits more than wages will benefit capital owners relative to workers. By contrast, other transmission channels work in the opposite direction. For example, if expansionary monetary policy succeeds in integrating previously unemployed individuals in the labor market, this will tend to decrease inequality.[16]

Complementary research has focused instead on the impact that monetary policy has on inequality via promoting its above-mentioned objectives of low inflation, employment, and financial stability. Beyond the well-established point that inflation favors debtors and harms creditors, a number of recent papers that look at the relationship between the inflation rate and inequality have come to diverging conclusions.[17] At first glance, the link between employment and inequality seems to be a straightforward inverse relationship, but its strength in part depends on the structure of unemployment benefits of a country. Finally, certain monetary policy interventions that target financial stability, especially the decision regarding which banks to bail out and which ones to let fail, clearly have distributive implications, even though in this case it is difficult to identify systematic trends.

In sum, I think it is fair to say that the jury is still out on the relationship between *conventional* monetary policy and inequality. In fact, given that the composition of different transmission channels and of the causal factors at work varies over time, it seems unlikely that there is a stable relationship between the two at all.[18]

However, we can arguably have more confidence when making claims about the impact of certain kinds of
p. 238 unconventional monetary policy on inequality (see also Fontan et al. 2016, section 5). With interest rates at
↳ historical lows in recent years, capital owners have the opportunity to engage in carry trades and increase their wealth with little risk: they can borrow at a relatively low interest rate and invest at a relatively high one, without there being a significant risk attached to the investment. This observation holds in particular for large, active investors who can afford the financial services necessary to reap these benefits—smaller investors, by contrast, have suffered from the low-interest environment, which is preventing them from building up retirement savings. Karl Marx put his finger on it when he said that "[t]he antithesis between capitalist and worker, between big and small capitalists, becomes still greater since credit is only given to him who already has, and is a new opportunity of accumulation of the rich man" (Marx in McLellan 1977, 114). Many commentators argue that the low interest rates in the wake of the crisis of 2008, rather than triggering productive investment, have by and large fueled asset price bubbles (Jones 2013).

The same argument applies to the long-term refinancing operations (LTROs) of the ECB conducted in December 2011 and February 2012. Under these schemes, the ECB offered commercial banks credits of up to

three years at 1 percent. The programs turned out to be very popular, especially since they offered low-risk arbitrage opportunities. A bank would take the money and buy slightly higher yielding government bonds with it, thus making a nice profit at negligible risk. Whereas LTROs might conceivably have been defended in the immediate aftermath of the crisis by arguing that they were necessary to prevent money markets from freezing up, this argument is less plausible at the time when they were actually employed and when the pressure on banks' balance sheets had already eased considerably. Here, the goal was presumably to incentivize banks to pass on loans to corporations and thus to stimulate productive investment. This goal was not attained. In fact, the ECB implicitly acknowledged that the first two rounds of LTROs had failed: for the third round of so-called TLTROs (targeted LTROs) in June 2014, it imposed explicit criteria to focus on the funding of loans to the non-financial private sector (excluding loans to households for house purchases).[19]

These examples show that when it comes to some of the unconventional tools of monetary policy deployed in response to the crisis, we clearly face trade-offs between some of the standard goals of monetary policy on the one hand—employment and financial stability in particular[20]—and containing inequality on the other. Especially if one is sceptical about the employment effect of expansionary monetary policy in a crisis like the present one, or if one thinks that financial stability could be promoted equally well or even better through alternative means, then one is likely to think, for example, that the price of LTROs in terms of increased inequality is not worth paying.

p. 239 It is worth highlighting one particularly tricky aspect of these trade-offs. Most policies will have both a *direct* impact on inequality—LTROs for example give capital holders cheap arbitrage opportunities and thus increase inequalities—and an *indirect* impact on inequality—if it were true, for instance, that in the absence of a particular LTRO program, credit markets would have ground to a halt and sent the economy back into recession, then deploying them will arguably decrease inequalities (or at least keep them at a lower level compared to the relevant counterfactual). The counterfactuals required to weigh these different considerations will always both depend on the reaction of financial markets to monetary policy, as highlighted at the outset of this section, and be hotly contested (see also Section 10.4). However, this is not an excuse not to engage in them.

10.3.2 The normative question

Should we care about the impact of monetary policy on inequality? (See Fontan et al. 2016, section 4.) This depends on what theory of justice we endorse, and what kind or what level of inequalities this theory deems unjust. If you think that current inequalities of income and wealth are problematic from the perspective of justice, then you should be concerned about monetary policy that exacerbates these inequalities.

It is not my goal in this chapter to defend any particular theory of justice. I merely intend to point out how a number of commonly held theories of justice might react to the empirical link between monetary policy and inequality we have analyzed in the previous section. The following theoretical positions are discussed in ascending order from less demanding and more consensual theories, to more demanding and also more controversial theories of justice.

Consider first a rights-based theory of justice that holds that inequalities in income and wealth are problematic only to the extent that they lead to the transgression of political rights.[21] Second, think of a needs-based theory of justice that requires a level of sufficiency in the standard of living for everyone to be met (e.g. Frankfurt 1987). Both of these first theories are relatively minimalist in their demands of justice. Any inequalities in income and wealth that do not violate these criteria, and by extension any inequalities of this kind that result from monetary policy, would be deemed acceptable.

Third, consider a Rawlsian argument defending the idea that inequalities are acceptable provided they benefit the least advantaged members of society (Rawls 1999). Think back to the LTRO programs I discussed
p. 240 in the previous ↳ section, which disproportionately benefit capital owners who tend to be rich. As long as they do not worsen the absolute position of the least advantaged in society, they would satisfy Rawls's difference principle.[22] Let me add two observations here. First, as G. A. Cohen (2008, especially chap. 1) has argued in a poignant critique of Rawls's reasoning, it is not clear whether incentive payments to the rich are actually compatible with a just society. Second, even if one thinks that the difference principle survives the critique formulated by Cohen, it is worth noting Rawls's particular way of conceiving the relationship between efficiency and equity. Rawls assumes that the two values are compatible, and that the difference principle serves to pick out one particular distribution among a series of Pareto-efficient distributions (Rawls 1999, section 12). This perspective assumes away potential trade-offs between equity and efficiency. More realistically, however, the relationship between the two values is more complex and does involve trade-offs. The same is true for the relationship between equity and the standard goals of monetary policy introduced in Section 10.2. In this chapter, I will not defend a particular way of arbitrating these trade-offs, but merely argue that we have to take them seriously.

Fourth, post-Rawlsian liberal egalitarians defend the idea that all undeserved inequalities should be compensated for (e.g. Dworkin 1981). Notably, they argue that the distribution of income and wealth should be insensitive to both natural and social endowments. If it turned out that monetary policy undermined this ideal, liberal egalitarians of this stripe would consider it problematic.

Fifth, some theories of justice appeal to an independent standard of merit to determine what levels of inequality are just. For example, one might argue that today's incomes are out of sync with the economic contributions of the individuals that earn them.[23] If monetary policy accentuates this discrepancy, then trade-offs of the type discussed above arise. If the theory of justice turns out to be less tolerant of inequalities than a Rawlsian position, then it would arbitrate these trade-offs in a different way.

The above theories of justice and their respective tolerance of inequalities are summarized in the following table (Table 10.1).

Table 10.1. Different normative positions on the acceptability of inequalities

What kind/level of economic inequalities is unacceptable, and why?		
Transgression of political rights view	Only inequalities that undermine political rights are problematic	Increasing demandingness ↓
Sufficientarian view	Above a minimum threshold of material resources for everyone, inequalities are unproblematic	
Rawlsian incentives view	Inequalities are unproblematic provided they improve the situation of the least advantaged	
Liberal egalitarian views	Inequalities that reflect natural or social endowments are problematic	
Desert views (contribution, effort, etc.)[a]	Inequalities are acceptable only to the extent that they track an underlying criterion of desert	

[a] Whether desert views are more demanding than liberal egalitarian views is an open question.

At this point, you might object that there is an argumentative gap between the various theories of justice invoked in this section and the empirical link between monetary policy and inequality discussed previously.
p. 241 This is a fair point. All of the theories of justice discussed here are ones that address ↳ inequalities of income and wealth in general, rather than specifically inequalities that arise from monetary policy. What consequences does this have for the assessment of monetary policy from a normative viewpoint? First, it means that this assessment will be context-dependent. In a society with low levels of inequality or with a relatively undemanding conception of justice, a particular monetary policy intervention and its effects might be considered acceptable, whereas the very same intervention might be deemed problematic in a society that starts from a higher level of inequalities or that has a more demanding conception of justice, or both. Similarly, under one set of regulations of financial markets, a particular monetary policy might generate fewer inequalities than under another, presumably laxer, set of regulations. From the perspective of inequality, the monetary policy in question might well be problematic in the latter context, but acceptable in the former.

Second, note that even if one accepts my argument so far—both the empirical claim that there is a link between monetary policy and inequality, and the normative claim that these inequalities should be weighed against traditional objectives of monetary policy—this does not yield any action-guiding conclusions as to what monetary policy should look like. In particular, someone might argue that the best way to arbitrate the trade-offs highlighted above is to have central banks pursue their mandate as currently defined, while the task to address any resulting inequalities falls to the fiscal and social policy of the government, for example through progressive taxation or unemployment benefits. This leads us to the institutional question to which we now turn.

p. 242 ### 10.3.3 The institutional question

Assuming we care about inequalities stemming from monetary policy, what should we do about this fact? We have two basic options. First, we could pursue what one might call an *integrated approach*. From this perspective, distributive concerns should be part of the central bank's objective function, which itself is informed by the overall social welfare function. When the chairwoman of a central bank is asked what the impact of her policy is on inequalities, neither "I don't know" nor "This falls outside my mandate" would be acceptable answers.[24]

Second, we could adopt a *division of labor approach*. Under this arrangement, the central bank pursues its traditional mandate as discussed in Section 10.2, while questions of distributive justice are taken care of by the government through its tax and transfer policies. Economists and central bankers tend to favor a division of labor of this kind.

However, any introductory economics course will tell you that such a division of labor is inefficient, at least in principle. How so? Well, the division of labor will lead to two local optima—a monetary policy one pursued by the central bank, and a social justice one pursued by government—which will clearly *not* result in a global optimum with respect to the overall social welfare function.

Granted, the advocate of the division of labor approach might concede, the global optimum will be out of reach, but as the experience of the 1970s onwards shows, the same holds for an integrated approach. When monetary policy is "politicized," it tends to lose credibility—in part, because politicians cannot resist the temptation to use it to promote their prospects of getting re-elected (Kydland and Prescott 1977). Thus, so the argument runs, even though a division of labor might be inefficient in the way I pointed out, it is a second-best solution to a problem the first-best solution to which is out of reach.

This comeback by the defender of a division of labor approach is well taken, but three observations need to be added here. First, the idea of conducting monetary policy and then correcting for any undesired

inequalities afterwards comes with serious drawbacks itself. Once people receive a given pre-tax income, they tend to develop a sense of entitlement to this income—a phenomenon Murphy and Nagel (2002) have called the "myth of ownership." This imposes serious feasibility constraints on the redistribution required by the division of labor approach.

Second, the argument for a division of labor concedes that it is ultimately an empirical question which
p. 243 institutional set-up for monetary policy best balances ↳ our different social objectives. I do not have the evidence at hand to decide which of the two ideal-type institutional arrangements discussed here is preferable today. I merely want to point out the following: If it is true that unconventional monetary policies today have more inegalitarian consequences than traditional monetary policy did twenty or thirty years ago, then this might well reopen the question of whether monetary policy should be conducted in isolation from other policy objectives. Today, the costs of an integrated approach and the political temptations it brings might well be smaller than the costs of a division of labor approach in terms of rising inequalities.

Finally, there may be a third way between the integrated approach and the division of labor approach, namely one that requires central banks to be sensitive to distributive considerations not as a matter of principle but when pursuing certain kinds of monetary policy that are known to have particularly inegalitarian consequences. Fontan et al. (2016, section 6) defend such a view when they argue that central banks should have to factor distributive effects into their decision-making when adopting extraordinary policy instruments of the kind we have seen since the 2008 financial crisis.

This section has not yielded any action-guiding conclusions about how to make monetary policy sensitive to inequality. This might be considered unsatisfactory. However, any stronger conclusions are unwarranted without further empirical analysis.[25] Moreover, I believe that the mere framing of the issue in the above terms is a worthwhile exercise. Those making monetary policy today do not tend to think in the categories employed here.

10.4 Optimal monetary policy, but optimal for whom?

In addition to its impact on inequalities of income and wealth, I will now argue that contemporary monetary policy raises questions of democratic legitimacy. On paper, there is no ambiguity. The mandate of central banks requires them to pursue some particular mix of the standard objectives—low inflation, employment, and financial stability—for the polity of the state or currency union in question. The rhetoric of central bankers confirms this picture. For example, when asked to take into account the impact of Federal Reserve policy on developing countries, Janet Yellen stated in February 2014 that US monetary policy will only take into account economic conditions in the US (Financial Times 2014).

p. 244 Yet, even though monetary policy is thus made *for* the polity in question, it is not made *by* the polity in question in the sense that central bankers are not democratically elected officials but appointed on the basis of their expertise. There is merely an indirect kind of democratic accountability, in the sense that governments are free to change the mandate of central banks.[26]

Despite the fact that central banks thus operate at arm's length from democratic control, the notion of optimal monetary policy is built on the implicit premise that the policy is optimal for the polity in question. Does this premise hold in practice? Arguably, monetary policy today also serves a "second constituency" (Streeck 2013, 118ff.). One can easily see what this means by looking at whom central bankers address in their policy statements: the "confidence" and reaction of financial markets play an important role in monetary policy setting. Central bankers do not want to upset financial markets, because they need the cooperation of markets to achieve their policy objectives. In particular, they need markets to invest capital in order to promote employment.[27] As highlighted from the very beginning of this chapter, monetary policy

is thus mediated by the reaction of financial markets, or, put differently, markets have considerable leverage over monetary policy. It is in the influence that financial markets have over policy agendas as well as outcomes that this influence is most markedly visible. To capture this idea, let us say that *financial markets act as a filter for monetary policy*.

Consider the following examples. First, it is plausible to think that in the absence of the strong reaction from financial markets to the mention by the Fed in May 2013 of the mere possibility of tapering asset purchases, the Fed would have tapered sooner and more decisively. Second, the leverage of markets over policy can be witnessed in appointment procedures for positions at central banks, notably for the position of chairman. For example, when Bill Clinton considered Alan Blinder as a possible replacement for Alan Greenspan in the 1990s, the markets sent a clear signal that they would disapprove of this change. Presumably, we can interpret this as a sign that as chairman of the Fed Blinder would have given the employment objective more weight than Greenspan, thus strengthening the position of labor vis-à-vis capital.

Someone might raise the following objection to the idea of financial markets acting as a filter. Contrary to my claim, what best serves the economic interests of the citizens living in a currency area clearly has to take
p. 245 into account the ↳ reaction of financial markets.[28] If the citizens are worse off, given the financial markets' reaction, in an early-taper world or in a world with Blinder as Fed chairman, then my claim that they would be better off in those scenarios is simply nonsense. To rebut this objection, we need to draw a distinction between a locally optimal policy *versus* a globally optimal policy. The Fed believed, I take it, that the early-taper or Blinder-as-chairman scenario would better serve the social welfare function of Americans, *ceteris paribus*. However, given that financial markets react differently to the various policy options, *ceteris* are not *paribus*. The globally optimal policy would be an early-taper or Blinder-as-chairman scenario in which financial markets react in the same way as in a late-taper or Greenspan-as-chairman world. By contrast, the locally optimal policy, taking into account the response of financial markets, is the late-taper or Greenspan-as-chairman.

My critic will interject that the globally optimal policy world was simply not accessible for the Fed at the time. Now, I agree that it would be nonsense to designate an unfeasible policy option as the globally optimal one. However, I contest that the globally optimal policy is unfeasible in a strict sense. The reaction of financial markets is conditioned on the regulation of the latter. Central banks, through and with the help of governments, can modify this regulatory framework. If it is possible, through regulatory reform, to reduce the set of possible responses by financial markets in order to better serve the social welfare function and get closer to the global optimum, then this is what should be done. In other words, the reaction of financial markets should not be taken as an exogenous parameter, but should be an endogenous variable of policy design.[29]

Why should we think the fact that financial markets act as a filter for monetary policy poses a problem from a normative perspective? There are two complementary answers to this question. First, since it is fair to assume that financial markets represent the interests of capital, their leverage over monetary policy is likely to exacerbate inequalities in income and wealth. This may well be considered problematic for the reasons discussed in Section 10.3. Second, if one accepts economic self-determination as a value to underpin the idea that monetary policy is made for the polity of the state or currency union in question—and I grant that I have not justified here why one should accept this value—then any bias that is introduced into monetary policy from the outside is problematic.[30]

p. 246 Where the interests of the second constituency of monetary policy—financial markets—are in conflict with those of the first—the polity—and end up trumping them, this undermines economic self-determination in a problematic fashion (see also Dietsch 2016).

Let me add a clarification as to what I am *not* claiming when characterizing financial markets as filters. I am not defending some kind of conspiracy theory suggesting that central banks covertly promote the interests of capitalists. Instead, the claim is that global capital, via financial markets, has undue leverage to set the agenda when it comes to choosing the means from the policy menu to promote domestic welfare. The notion of what constitutes an undue leverage here needs to be specified further. For now, let us say that the members of a subgroup of a constituency have undue leverage when they have sufficient influence to lock the polity into a suboptimal policy. This seems to be the case with regard to financial markets and monetary policy.

Finally, what should be done about this problem? Giving governments more control over monetary policy is not a promising solution. Against the background of increasing public debt, governments would be just as much hostage to financial markets as central banks, if not more so. Take the example of the US: Despite the fact that US officials often complain that China's buying of US treasury bills amounts to a competitive devaluation of the Renminbi, the US would be left high and dry without the constant Chinese demand for its debt.

(Financial) markets acting as a filter for (monetary) policy represents the type of scenario that Karl Polanyi's (2001 [1944]) critique of market liberalization issued a powerful warning of. Polanyi argued that when pushed into a corner by the forces of deregulated markets, societies would inevitably take measures to protect themselves. In the pessimistic scenario, which is the one that played out in Polanyi's time, they protect themselves against the market by sacrificing freedom. In the optimistic scenario, which is still possible but once again on the back foot today, they protect themselves through a coordinated regulation of the market. Multilateral regulation is a necessary condition for attaining the globally optimal policy discussed above. Unilateral efforts by central banks or governments are trapped in locally optimal policy sets, exacerbating the tension between the two constituencies of the demos and the market.

10.5 Conclusion

In an era where monetary policy has become the primary tool of macroeconomic policy, it is natural to subject it to normative scrutiny. This chapter has done so from two complementary angles. First, I have
p. 247 shown that unconventional monetary policy instruments of the kind employed today have an ↳ exacerbating impact on inequalities in income and wealth. Depending on their demandingness, theories of justice will consider this impact problematic to varying degrees. However, this normative conclusion leaves the institutional response to it underdetermined. The costs of having an independent central bank with a narrow mandate that fuels inequalities in this way will have to be weighed against the costs of a more integrated approach to public policy, where monetary policy is coordinated with other measures.

Second, the sensitivity of central banks' policy-making to financial markets raises the question of whether financial markets introduce a bias into monetary policy. More specifically, is it the case that financial markets act as a filter for monetary policy? If it is empirically adequate to say that financial markets have enough leverage over monetary policy to take policy options off the menu that would better promote the interests of the polity of the country or monetary union in question, then this raises questions of democratic legitimacy. Any effective remedy to this second issue requires multilateral reform.

Finally, it is worth highlighting again another important upshot of this chapter. When thinking about normative dimensions of monetary policy, we should not take the reaction of financial markets as given, but rather treat it as an endogenous variable that can itself be modified by monetary policy and by the regulatory framework more generally.[31]

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Notes

1 But see Fontan et al. (2016) for a recent assessment of the relationship between central banking and inequality.
2 For a pioneering discussion of the third dimension, see Reddy (2003).
3 For a representative statement of the importance of price stability from the perspective of contemporary monetary theory see Woodford (2003, chap. 6).
4 Statistics show, for instance, that the Japanese, given their bad experiences with deflation, tend to hold a large proportion of their savings in cash deposits (see Saiki and Frost 2014, 5).
5 Austrian economists disagree with this view. They hold that deflation when due to technological progress rather than insufficient demand is not problematic and quite compatible with economic growth.
6 There is a heated debate among academics and central bankers as to whether financial stability *should be* among the objectives of central banks or not. Some argue that an effective promotion of price stability presupposes a narrow mandate that excludes other objectives (e.g. Issing et al. 2001), others maintain that the stabilizing function of the central bank's liquidity management constitutes the essence of central banking (Goodhart 2010, 9) and thus favors a broader mandate. I set aside this debate for the purposes of this chapter.
7 That is, the fact that under fractional reserve banking, commercial banks tend to *borrow* money for relatively short periods while they *lend* money for relatively long periods.
8 As indicated in the introduction, this chapter is only concerned with financial stability to the extent that it is conducted through monetary policy, but sets aside macroprudential policy.
9 I thank Alex Barkawi for his comments on this section.
10 When the central bank buys government bonds, this props up their price and, through the inverse relationship between price and yield, keeps their yield and thus the money market interest rate low. Conversely, when the central bank sells bonds, this raises the money market rate.
11 When the central bank buys long-term government bonds, whose prices correlate with future short-term government bonds, they are sending a signal to investors that interest rates will *stay* low for a while.
12 See for instance the 6-month, 12-month, and finally 36-month long-term financing operations (LTROs) introduced by the ECB in the wake of the crisis.
13 For the case of the Fed, see for instance Mehrling (2011, 3).
14 The first rounds of quantitative easing by the US Federal Reserve, for instance, included a significant amount of mortgage-backed securities.
15 For a good overview, see the five transmission channels identified by Coibion et al. (2012).
16 Coibion et al. (2012, 2) call the first transmission mechanism the "income composition channel" and the second the "earnings heterogeneity channel."
17 Jovanovic (2014) suggests that higher inflation tends to reduce inequality, Albanesi (2007) argues that the opposite is true, while Monnin (2014) holds that there is a U-shaped relationship between the two, with inequality high at both very low and high rates of inflation, whereas it tends to be lower at moderate rates of inflation.
18 I thank Nancy Cartwright for pushing me to make this explicit. I am bracketing here the idea that the very fact of money creation in an economy might have inegalitarian consequences (e.g. Baeriswyl 2015).
19 I thank Alex Barkawi for helping me to make this point more precise.
20 Trade-offs between inflation and inequality seem to be rarer or less obvious.
21 For a classic statement of this kind of position, see Okun (1975, chap. 1). Michael Walzer's (1993) theory of *spheres of justice* can also be interpreted in this way.
22 At least on a relatively weak interpretation of the difference principle. A more demanding interpretation requires that the inequality in question *better* the position of the least advantaged, rather than merely *not worsen* it. Thanks to Lisa Herzog

for her suggestion to clarify this point.

23 Within this family of views, we again find different levels of demandingness. For a radically egalitarian position on the distribution of labor incomes, see for example Dietsch (2008).

24 For an in-depth analysis of the discourse of central bankers about inequalities, see Fontan et al. (2016).

25 For an important step in this direction, see Fontan et al. 2016.

26 When we speak of independent central banks, we need to distinguish between goal independence—which is constrained by the government's capacity to change the mandate—and instrument independence, which refers to the freedom of central banks to use the instruments at their disposal—setting interest rates as well as conducting open-market operations—as they see fit. The "independence" of central banks usually refers to the latter.

27 Even where employment is not officially part of the mandate of the central bank, a slump in employment poses a deflation risk, which *is* part of the mandate.

28 I thank Alex Barkawi for raising this objection.

29 A parallel can be drawn here to international tax governance, where "market reaction" in terms of tax evasion or tax avoidance can and should be controlled by government policy rather than taken as given in tax setting (Slemrod 1994; Dietsch 2015, chap. 3).

30 Due to space constraints, I bracket the question of whether there is a difference between domestic *versus* foreign capital exercising this influence. Przeworski and Wallerstein (1988, 24) argue that the state is structurally dependent only on foreign capital, whereas a variety of redistributive policies is compatible with continued domestic investment.

31 Previous versions of this chapter have been presented at a workshop on "Normative Dimensions of Monetary Policy" at the Centre de recherche en éthique (CRÉ) in Montréal in April 2014, at the conference "Monetary Policy and Sustainability," organized by the Council on Economic Policies (CEP) in Bellagio in June 2014, and at the workshop "European Central Banking after the Global Financial Crisis" at the European Union Center of Excellence at McGill University in September 2014. I thank participants at these events, in particular Alexander Barkawi, Romain Baeriswyl, François Claveau, Clément Fontan, Frank Garcia, Aaron James, Juliet Johnson, Laurence Kotlikoff, Marco Meyer, Pierre Monnin, Martin O'Neill, Sanjay Reddy, Tom Sorell, and David Woodruff for their comments.