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The Democratic Challenge of Central Bank Credit Policies

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Abstract: This article provides a framework for understanding the economic role of central banks and their democratic legitimacy. I argue that thinking about the democratic challenges of central banking requires considering central banks' *insurance* role and how their actions are part of *credit policy*. The contract between the central bank and the sovereign is incomplete because it cannot integrate all unforeseen contingencies, distributive consequences and interactions with other policies. This opens the door to viewing the legitimacy of central bank decisions through a process of deliberation, coordination and reflexivity, rather than only a delegation of power. I discuss a proposal for a European Credit Council, which would be a deliberative body aimed at strengthening Parliamentary power on monetary and credit policies, the democratic legitimacy of central bank policy in the Euro Area as well as its coordination with other European policies. More coordination, Parliamentary power and deliberation are consistent with central bank independence and aim to delimit more precisely the action of central banks within the macroeconomic and credit policies of the State.

Keywords: central banking, credit policy, monetary policy, deliberative democracy, welfare state

JEL Classification: E4, E5, G2, H8, O2

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The extent of central bank actions is so large that they interact with many other realms of public policy.[1] These interactions were usually downplayed both in academic and central bank discourses in the 15–20 years that preceded the Global Financial Crisis of 2007–2008.[2] Once these interactions became visible, they led to public criticism of central banks and even to court cases, but without giving rise to an explicit new institutional framework. We are left with an unsustainable gap between what central banks actually do and the institutional framework that defines their responsibility.

Many still consider the 1990s – when the central bank legal and political framework was indeed reshuffled – as the period of normality ("conventional

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1 This article builds on some of the arguments presented in the short book *La Banque-providence* (Monnet, 2021). An English translation of the book (updated and twice longer) is forthcoming at Chicago University Press. I am much grateful to Matthias Thiemann for organizing this symposium, as well as to him and Yuri Biondi – the editor of Convivium – for providing comments on the first draft of this text. I owe a great debt to many colleagues and co-authors in academia and central banks who shared criticisms and comments, but I remain solely responsible for the views presented here.
2 There is of course a very long tradition – that never really vanished – of discussing the large perimeter of central bank actions. See for example the discussions about credit policies below, or Moe (2013) as an introduction to some interwar debates.

policy") to which we are to come back as soon as possible.[3] My contention, already shared and formulated by others, is that it is an illusion.[4] Important structural changes should prevent us from thinking that central banking will revert to its 1990s model: the large stock of public debt held by central banks, their commitment to act to preserve the natural environment, the prospects for future financial crises in an increasingly financialized and affluent world, the growing awareness of the distributional effects of monetary policy in the academic literature and in the public sphere, as well as the shift to digital money. The come-back of inflation only makes the current situation more specific and challenging. Even if price stability remains the main objective of central banks, no one can deny the interactions between this objective and other macroeconomic policies (related to financial, energy, environmental, public debt or fiscal issues). Among these different issues, the most novel for the future policy of central banks is undoubtedly climate change, as it implies the introduction of normative criteria in central bank lending and in the definition of the price index (Dikau & Volz, 2021; Monnet, 2021; Smoleńska & van't Klooster, 2022). Central banks, however, are not currently equipped to have the necessary legitimacy to make these normative choices. The area of normative discussion on these issues remains to be constructed.

The risks are clear. On one hand, failing to recognize the interactions between monetary policy objectives and other public policies can lead to major deficiencies. This proved to be the case with financial stability in the 2000s. This could be about – no less than – inflation, public debt and the climate today. On the other hand, there is a real danger to think that central banks alone can save the world, armed with their expertise but without democratic accountability. This could not only be a danger to democracy, but also an excuse for governments not to do enough.

In my mind, a major overhaul does not require central banking to break with the legal statutes of the 1990s, but to adapt the democratic framework of central banks to the actual scope of their policies and to the challenges ahead. Adapting the democratic framework is not about changing the constitutional law. It requires more

3 The 1990s perspective on central banking is perfectly summarized in Clarida et al. (1999). Some of these authors have later modified their view on the matter. In the United States, the Greenspan era of the 1980–1990s was also characterized by a shift towards more independence from the government and a neglect of interactions between monetary policy and other policies, but – contrary to many other OECD countries – there was no important change in the legal framework of the Federal Reserve System (Conti-Brown, 2016; Siklos, 2002).

4 Monnet (2021) synthetizes a growing and already large literature, especially in economics, political sciences, law and political philosophy, that has stressed the distributive effects of central bank policy, their embeddedness in the power of finance, the necessity of both giving more powers to central banks to address future economic issues (including climate change) and ensuring more democratic control.

coordination and more deliberation. It is both a matter of democratic legitimacy and of economic efficiency.

Before discussing institutional reforms and potential policy changes, I present four main arguments that are necessary to assess what central banks can and cannot do. First, the *raison d'être* of central banks is to provide insurance to the State and to financial markets. The insurance function of central banking is not only the one of lender of last resort in extreme events. It involves a continuous flow of liquidity that has a fundamental ambiguous role: grease the wheels of financial intermediation while protecting it against a mechanical runaway. In that sense, insurance and assurance functions are mixed, but the risk never disappears. As Charles Goodhart (1988) already underlined, these insurance functions create moral hazard, as with any type of insurance. This raises a key policy question: what are the conditions for insurance? Unlike others, I do not believe that this question can be resolved solely by writing a precise central bank mandate. And in fact, central bank mandates are not – and never were – precise. Central bank insurance is a very incomplete contract, incapable of incorporating all contingencies. Therefore, it is as important to have a well-defined contract as it is to have a framework that recognizes and organizes how to discuss the terms of insurance as well as the response to contingencies in a democratic setting.[5]

Second, the insurance role of central banks was profoundly altered in the mid-twentieth century, with important consequences for the relationships between economics and democracy. This shift was not so much about the operating procedure of central banks – changes occurred in that respect but not more than in other periods – but about the beneficiaries of the insurance and, thus, the nature of the contract. In few years, from about the mid-1930s to the mid-1940s in almost all countries, banking systems started to be regulated and the macroeconomic and social role of the State fundamentally changed (towards welfare programs and macroeconomic stabilization). As a consequence, central banks became part of the public administration and discovered macroeconomic policies; fluctuations of prices, unemployment and GDP having themselves large effects on the State budget and the implementation of welfare programs.[6] This is the main turning point in the history of central banks, an aspect often downplayed after the neoliberal turn of the 1980s and 1990s emphasized the importance of central bank independence.

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5 Banking regulation can be seen as a condition for insurance. Yet, it does not solve the issue of the incomplete contract since central bank actions also affect non-banks and – most important – because the extent and mode of central bank operations is never fully defined in advance.

6 There is no doubt that postwar central banking (including its current form justified by standard macroeconomic theory as a way to manage macroeconomic variables) would have scared the free-market economists of the interwar. Observing the birth of the reforms in central banking in the 1930s, Henry Simons (1936, p. 3) wrote "Managed currency (along with protectionism) is the prototype of all current "planning" schemes – in the sense of all the illiberal connotations of planning."

Third, central banks are always involved in some type of credit policy, but they are only one actor among others in credit policy. Credit policy refers to all dimensions of money and credit that deal with the allocation of funds and their distributional consequences. This includes financial regulation, government lending or subsidies, public investment banks, etc. Even if the distributional aspect of central banks' actions is minor, monetary policy cannot ignore the consequences of other major actors in credit policies. Coordination is thus warranted. Central banks, Treasuries and public development banks (for long-term investment) are financial engines of the State, but they remain distinct. Considering their potential coordination requires that they remain autonomous entities with distinct features, roles and operations. The emergence of macroprudential policy after 2008 has led to the recognition that central banks are concerned with credit in the same way as other public policy institutions. Yet macroprudential policy has remained confined to financial stability issues.

Fourth, viewing central banks as insurance and pillars of the welfare state opens the door to a reinterpretation of the democratic legitimacy of their independence. Clear principles of delegation and accountability are necessary for the legitimacy of an independent authority, but they are not sufficient. Legitimacy is a process that requires temporal reflexivity, balanced deliberation, impartiality, and coordination with other public policies. I defend the primacy of deliberation over delegation because only the former is able to fully integrate the role of the central bank in credit policy.

In what follows, I first discuss the insurance role of central banks and their relationship with the Welfare State. In a second step, I discuss how central banking should be reformed in order to increase coordination with other policies and democratic legitimacy, and why it does not contradict central bank independence. Starting from a general level argumentation and a presentation of two opposite views on central bank independence (which partly overlaps with the distinction between credit policy and monetary policy), I then turn to specific institutional proposals in the Euro area context. These proposals draw inspiration from both historical experience of coordination between central banks and other state bodies ("credit councils") and current macroprudential policy councils, while taking into account the criticisms and limits of these earlier examples.

1 Central Banking As Insurance

The idea that the primary role of central banks is to stabilize inflation by targeting interest rates is as narrow as the assumption of a neoclassical world with complete and efficient markets. It can be useful in theory but it leaves out the most important functions of central banks and all the economic complexities, political issues and potential conflicts associated with their role. It is of limited use in understanding the past and in grasping the current issues of central banking. We need a broader approach that can encompass different historical, current and future forms of central banking. In this respect, I build on Charles Goodhart who emphasized the insurance functions of central banks and their implications:

> With the Central Bank coming to represent the ultimate source of liquidity and support to the individual commercial banks, this micro function brought with it naturally a degree of "insurance." Such insurance, in turn, involves some risk of moral hazard. (Goodhart, 1988, p. 7)

Central banks work as an insurance through the provision of liquidity. This insurance works at several levels: payment system (for individuals and firms), financial system (for private and public financial entities), and the State (public debt). As long as domestic currency, central bank reserve and public debt are used to guarantee and settle private credit claims, these three levels are deeply intertwined.

Ensuring the safety and liquidity of the payment system has been performed in the past by other institutions than central banks. Although she does not use the term "insurance", Christine Desan (2014) explains how – before creating a central bank – the English government (like others in the same era) ensured that commodity money remained liquid. It involved guaranteeing the quality and convertibility of coins to make circulation safe as well as changing the intrinsic metallic value to avoid hoarding. In the 19th century, several countries introduced paper money without a central bank – including the United States. By contrast, insurance to the government and the financial system through the provision of liquidity is a key characteristic of central banks. They are financial institutions by nature, not printing presses.

Liquidity is not intrinsic to an asset and liquidity preferences are not given.[7] Liquidity must be guaranteed by the stability of the asset's value over time and by its wide acceptance in trade. Keynes (1973 [1936], p. 165) famously argued that "the rate of interest at any time, being the reward for parting with liquidity, is a measure of the unwillingness of those who possess money to part with their liquid control over it." Parting oneself from the high yield offered by an illiquid asset is only possible if there is a guarantee that the alternative monetary asset will remain liquid. Central banks provide this guarantee. There is a premium paid for holding money – the convenience yield – that is, for foregoing the higher financial returns of illiquid assets.[8] This convenience yield is an implicit contract

7 As formulated by André Orléan (2014, p. 114), "The interactions prompted by liquidity are typically mimetic in nature, since each person 's desire for liquid goods is modeled on the desire felt by others for these same goods. As in the case of prestige, what is liquid for an individual is what others consider to be liquid and desire as such. Accordingly, liquidity does not refer to any particular substantive quality that can be defined prior to market transactions."

8 On moneyness and convenience yield, see Gorton (2017). When nominal rates are negative, the price to pay for liquidity services is even higher than usual.

with the ultimate money issuer. The most specific power of the central bank is to make assets liquid, being the provider of "financial money of ultimate quality" (Bindseil, 2019).

The insurance component provided by the central bank by assuring liquidity is not just a temporary, short-term option. It is not just a loan of last resort. Central banks build and manage money markets – ensuring that the value of the collateral remains stable, what Perry Mehrling (2010) calls the "dealer of last resort" – whether they are markets for government debt or private debt claims. One of the most telling historical example is the role played by central banks in the nineteenth century (Bazot, 2014; Ugolini, 2017), when they established branches throughout their country to unify the national credit market by settling claims and providing liquidity (through the discounting of commercial paper). By providing an "elastic currency", they cushioned financial shocks and were able to limit the volatility of credit and interest rates (Bazot et al., 2022).

In a market-based financial capitalism, liquidity must be a general rather than a local attribute. In this case, the central bank has no control over the ultimate investment of the institutions to which it lends.[9] Transmission works through the market; central bank liquidity provision can potentially fuel any kind of either investment or speculation.[10] By contrast, when markets are segmented (by forms of capital controls, at the regional or sectoral level), liquidity is a local concept. The provision of liquidity by the central bank is no longer a support to the "market" but a subsidy to a specific type of economic activity, or to interest groups (Monnet, 2018).

The "market", however, is not an anonymous creature. In practice, whatever the form of the financial system, the provision of liquidity by the central bank always ends up supporting the activity of certain actors. Central bank liquidity provision is always a form of economic interventionism. Once this simple fact is recognized, the very political question for central bank legitimacy is to determine the conditions under which liquidity provision objectives support the public interest.

This is all to say that attempts to drive politics out of central banking are illusory. Below, I will discuss how this remark can be translated into the distinction between

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9 It has only control over the assets which are admitted for refinancing as collateral and the depository institutions which have access to those facilities In a market-based system, where public debt is the safest asset, the provision of liquidity by the central bank has the dual role of guaranteeing public finances and private market interests, thereby supporting the private-public interlocking that is the backbone of market economy (Bateman, 2021; Gabor, 2016; Kapadia & Lemoine, 2020). Daniela Gabor (2021) has characterized this current situation as the "shadow regime."

10 "For this reason, in capitalist economies money is also a means of speculation, the rapid conversion of capital in and out of assets in pursuit of short-term pecuniary gain. A liquid asset thus offers its owner a precautionary lull from disquietude but also an energetic means of speculation, of rapid investment and disinvestment." (Levy, 2021, p. xxiii).

credit policy and monetary policy. In Monnet (2021), I discuss how central banks' ambiguity towards market-based finance can be interpreted through the light of the notions of commodification and decommodification, as defined by Karl Polanyi. Indeed, I am not doing much more than updating Polanyi's thought on central banking as summarized in these two quotes:

> Modern central banking, in effect, was essentially a device developed for the purpose of offering protection without which the market would have destroyed its own children, the business enterprises of all kinds. Polanyi (2003 [1944], p. 201)

> Indeed, the great institutional significance of central banking lay in the fact that monetary policy was thereby drawn into the sphere of politics. The consequences could not be other than far reaching. [...] In the domestic field, monetary policy was only another form of interventionism, and clashes of economic classes tended to crystallize around this issue so intimately linked with the gold standard and balanced budgets. (ibid. p. 207)

2 Central Banks and the Welfare State

The insurance role of central banks – which has existed since their origin and applies equally to the state and to financial institutions – was transformed in the middle of the 20th century by changes in economic policy that are generally and crudely associated with the "birth" of the Welfare state. The needs to ensure macroeconomic and financial stability or to buy public debt do not have the same political meaning in today's society, where the state finances public goods (and partly social welfare) and the central bank is a public administration.[11] This stands in sharp contrast with the period when the state budget was mainly devoted to military defense and the central bank was in the hands of private shareholders. Most central banks that already existed in the 19th century acquired a public status in the 1930s or 1940s only. This was historically associated with the birth of macroeconomic policies as we know them today, that is using the public budget and money creation to stabilize the business cycle and offer protection to citizens against adverse macroeconomic shocks. It is this historical break, almost obvious, that one must be aware of in order to think about the extent of the political role that central banks play today. This position does not imply that central banks have been constantly mobilized since the 1950s to defend the welfare state or that they were refractory to defending the interests of private financial actors. The relationship of central banks to the State and

11 In OECD countries, in 2020, 40% of government expenditures are social benefits (46% in EU) and 22% compensation of employees (20% in EU). The reminder is mostly intermediate consumption and investment, as well as interest rates payments (6% for OECD, 3% for EU). Overall, around 55% of total expenditures are devoted to social protection and health. See OECD (2021).

to financial actors is changing and complex, subject to reversals and – during the 1980s and 1990s – submitted to a marked liberal turn. The political evolution of central banks since the 1950s reflects the changes in the welfare state itself, including the turn to financialization.

Without thinking about the historical process of integration of central banks into the State, it is also difficult to understand why the legal objectives of central banks are usually not only defined in terms of monetary and price stability. For example, the European Central Bank has as a secondary objective (i.e. "without prejudice to price stability"), to provide "support for the general economic policies of the Union", i.e. to support an economy "aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment." These words are not there by chance. They would have had no meaning before the second half of the 20th century.[12]

3 What Central Bank Independence Really Means

Recognizing that central banking is a matter of policy, rather than simply a technical matter, does not imply that central banks should be part of government. Economists, philosophers and political scientists have provided many justifications for central bank independence (Van't Klooster, 2020). Yet, central bank independence remains a confusing concept whose definition has varied greatly over time. The terms of the separation between the government and the monetary authority have been debated since the creation of central banks (Bindseil, 2019). It is always useful to remember that the very nature of a central bank is to make money management independent of the Treasury. A Treasury can perform many of the functions that we now attribute to a central bank.[13] Yet, as explained earlier, the advantage of having a central bank is to provide insurance to the Treasury itself as well as "elastic money" to the financial system. In addition to operational independence justified by the need to manage short-term liquidity, the best argument for central bank independence is that money

12 This is not legally contradictory with the fact that neo-liberalism also marks the ECB, since it is clearly stated that it must work "act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources." See Consolidated version of the Treaty on European Union PROTOCOL (No 4) ON THE STATUTE OF THE EUROPEAN SYSTEM OF CENTRAL BANKS AND OF THE EUROPEAN CENTRAL BANK, Article 2

13 As reminded by Friedman and Schwartz (1963, p. 149–152), the US Treasury could actually even perform central banking functions through providing liquidity in the form of deposits at national banks. This function was however limited by the political unwillingness to give too much money creation in the hands of the Treasury, so that it did not provide sufficient "elastic currency" to the US banking system. See Bazot et al. (2022) for quantitative evidence.

creation is a power so great that it could be used by incumbent policy makers to distort the terms of elections (by heavily funding certain projects or making credit cheaper to secure certain votes). From this perspective, independence is meant to protect democracy, not to work against it. And the conditions of independence, as well as the objectives and tools of the central bank are defined by the legislature, not against it. Thus it cannot be without constraints and strong accountability to prevent it from being used against the will of the people. This argument is not specific to central banks and applies equally in many countries to the judiciary, to authorities regulating business competition or the media, or to public investment banks.

In principle, the independence thus only concerns the operations of the central banks (lending and setting interest rates) that are deemed necessary to achieve an objective determined by the sovereign. Central banks do not decide on the organization of the monetary system. Giving legal tender to a currency and fixing the nominal value and convertibility controls on that currency (exchange rates and exchange controls) always belong to the government. Today, while central banks are state-controlled and central bankers are usually appointed by the government or Parliament, central bank independence is defined primarily by the prohibition of direct lending to the Treasury, the prohibition of political instructions or pressure from the government, as well as the impossibility to dismiss the head of central banks before the end of her/his mandate (Dincer & Eichengreen, 2014). A change in their statutes or government approval is usually required to expand the types of loans they make.[14] Finally, today's legal independence from political pressures goes hand in hand with legal independence from private interests (i.e. central bankers cannot be employees or shareholders of companies to which the central bank is lending to). There is however evidence of various forms of capture by the financial sector (see Mishra & Reshef, 2019; Monnet et al., 2019 for recent reviews). Central bank cannot work in isolation. Parliamentary scrutiny is indeed necessary to ensure that they are not captured by vested interests.

In practice, central bank independence raises three major questions.

1. *Enforcement of accountability.* How do we ensure that central bankers act for the public good (and to achieve the objectives set out in their mandate) rather than

14 An interesting recent example shows how sensitive but crucial is the legal right of a central bank to lend. The Federal Reserve made emergency loans to nonbank financial institutions in 2008 under the auspices of Section 13(3) of the Federal Reserve Act, which had been added in 1932 to allow the Fed to lend to mostly private non-financial companies amid the Great Depression (and collateral eligibility was widened after the 1987 crisis). This right has not been used for decades. After criticisms from the Congress, the 2010 Dodd-Frank Act modified the Section 13(3) to require government approval of this special lending. Subject to Treasury approval, the scheme defined in Section 13(3) has been the basis of most of the Fed program during the covid crisis to provide liquidity to municipalities or businesses through a special purpose vehicle.

trying to please the government in order to be reappointed, or to please the private banks in order to get a future job in that sector?[15] History casts a skeptical light on the importance of *de jure* central bank independence. Examples abound of supposedly independent central bankers who have either been subject to strong government pressure, used their symbolic power to pressure the government to implement reforms unrelated to monetary policy, or gave priority to defending the private profits of the financial industry. On the contrary, there are many examples of non-independent central bankers fighting to resist the government pressure in order to limit the risks of financial crises or price instability.

2. *Coordination with other policies.* Central bank operations have important distributional effects. The effects on the overall allocation of credit ("credit policy", see below) are most important when central bank operations are large, or when they are explicitly targeted. It is widely recognized that even interventions that are considered "neutral" (i.e. not targeted at specific institutions or activities) have substantial distributional effects on asset prices, consumption, etc. It is difficult to imagine a macroeconomic policy that does not have such effects. Coordination is therefore necessary when central bank actions have consequences for other public policies. Moreover, it is difficult for central banks to achieve their objectives without coordination with other policies. There are at least three well-known examples: administered prices (an important part of prices is *de facto* controlled, especially in the energy, housing, education and health sectors), fiscal policy and financial stability policy. After the 2008–2009 crisis, the need for coordination was recognized for these two specific reasons with respect to financial stability: central banks' actions have an impact on financial markets, but they are not the only institutions involved in safeguarding financial stability. This reaction has led to the institutionalization of macroprudential policy. The same reasoning applies to public debt management, economic inequality and green finance, but coordination is still lacking.
3. *Contingencies and interpretations.* Central bank mandates are vague and incomplete. Even when macroeconomic objectives are precisely defined, "they involve trade-offs, judgments about whether the risks of inflation are worth the benefits of lower unemployment. These trade-offs involve values." (Stiglitz, 1998, p. 217). In practice, macroeconomic objectives are vaguely defined in law. The central bank itself has to set a specific target for inflation, GDP growth or unemployment. The problem is, of course, all the more evident when the mandate contains very general statements such as the responsibility to "support the

15 These issues are well covered in Adolph (2013) and Fernández-Albertos (2015). Lastra (1996) provides a thorough legal discussion of the meaning of accountability as far as central banks are concerned.

general economic policies in the European Union." Finally, as we have seen repeatedly since 2008, not all contingencies can be accommodated in the legal status, so central banks continue to invent or reactivate policy tools whose legal legitimacy is sometimes questionable but which are deemed necessary to perform their insurance functions.

4 Two Views on Central Bank Independence

Nobody denies the political power of money. The difference lies in the solutions proposed to control the monetary power of central banks. There are roughly two different approaches.[16] The first, rooted in the principal-agent framework, limits the question of independence to the central bank's mandate, based solely on principles of delegation (Tucker, 2019). The mandate should be as precise as possible, considering all possible situations and indicating what the central bank should do in each of them. In technical terms, the central bank is to follow a precise rule that relates its instruments to its objectives and includes all contingencies (such as rules prescribed by Milton Friedman or John Taylor). The soft (and dominant) version of this approach circumscribes the rule-based approach to monetary policy and allows flexibility during crises as long as there is a commitment to come back to the standard rule. It also acknowledges that the issue of financial stability cannot be considered by the central bank alone and may need coordination with other institutions. The hard version of this approach is to explicitly cut monetary policy from the political sphere, without considering unforeseen contingencies nor financial stability issues.

A second and different view argues that the democratic legitimacy of independence cannot be based solely on the definition of the legal mandate (since the latter is never precise enough to consider all situations). It should rather be based on the quality of the democratic debate and the balance of power surrounding the decision of the independent authority (i.e. reflexivity and impartiality, in the words of Pierre Rosanvallon (2013)). I defend this second view – which is also based on a long tradition in political philosophy – because I consider it better suited to address the three concerns of central bank independence I have highlighted above: accountability, coordination and contingencies.

Both positions recognize the need for a mandate for an independent central bank, as well as the transparency of the decision-making process that compliance

16 A third view is total integration between the Treasury and the central bank. I let the discussion of this third view to another text. It is sufficient to say here that the arguments I have presented so far on the insurance functions of a central bank require a certain degree of separation between the central bank and the Treasury, so that monetary and credit policies exist on their own and are not conflated (but can be coordinated) with fiscal policy.

with this mandate implies. But the former sees *delegation* as the most important criterion, while the latter emphasizes *deliberation*. In the ideal of pure delegation that characterizes the first approach, the key is the definition of the central bank's mandate, anchored in law. Transparency in the implementation of monetary policy and the communication of the central bank are only a means to signify that the mandate is being followed to the letter. This transparency is itself technical (how best to explain the central bank's action) and therefore mainly unidirectional (from the central bank to the financial markets and citizens). Parliamentary control over the central bank is also conceived as a monitoring of compliance with the mandate and not as a place for discussion or political coordination (see Fraccaroli et al., 2022, for a review of US, UK and ECB institutional settings).

In the deliberative ideal, on the other hand, the importance of the legal framework is recognized, but it is considered insufficient from the outset. Legitimacy is built on the capacity of institutions to organize deliberation so that the decisions taken are justified not as the application of a technical evidence, but as the result of a choice between several positions whose social and economic consequences are made explicit.

The important dissonance between these two positions brings us back to the question of values that Stiglitz was talking about. In the ideal of pure delegation, the independent authority should never take a decision that would involve values not specified in its mandate. Paul Tucker, the most recent vocal advocate of this position in the field of central banking, sets out principles of delegation, one of which states that central bankers, because they are unelected, should not make "choices that relate to the distribution of income or the values of society, or that significantly alter the distribution of political power" (Tucker, 2019, DC5, p. 569).

But how is it possible to establish a mandate that anticipates all the complex situations and value conflicts that an independent authority such as the central bank may face? In practice, there are only two answers to this difficult question: either a rule is established that is so precise that the central bank becomes almost an automatic pilot (Bordo, 2019; Taylor, 2016); or the law produces an extremely abstract statement. It is generally the second option that is chosen in law but it is the first one that is supposed to be followed in practice. Apart from the mention of price stability, central bank mandates are, as we have seen in the case of the European Union, extremely general and open to interpretation. Interest rate rules or precise inflation targets are chosen by the central bank but – with few exceptions – not written in the law.

5 Deliberation and Reflexivity

Recognizing that central bank independence has historically been more a matter of practice than law, one rejects the idea that a clear legal status and mandate can be sufficient to ensure central bank legitimacy.[17] I therefore turn to that other philosophical tradition of democracy that gives a role to independent central banks by insisting on the *processes of deliberation and reflexivity* that must accompany independence. While recognizing the importance of delegation, this intellectual tradition starts from the principle that even a precise mandate does not prevent important choices being made which are based on values and have major consequences for economy and society. The political legitimacy of delegation therefore rests as much on the way in which this delegation is justified and debated through deliberation as on the initial mandate.

Pierre Rosanvallon, who defends this conception of democracy (more precisely, of democratic legitimacy), has devoted part of his work to reflecting on the democratic legitimacy of independent authorities like central banks. He insists on the importance of making "reflexivity and impartiality qualities that are constantly being put to the test before the eyes of the public"; "it is from an organized confrontation between rulers, with a contradictory understanding of the world, that democracy will increasingly be nourished" (Rosanvallon, 2013, p. 238, 258). The reflexive legitimization of a decision involves that the authority making decision is able to express the general will thanks to the formulation and discussion of different interests and different potential outcomes. This process is explicitly opposed to the idea that the general will is already defined in the constitutional law. How can institutions be set up to make the independence of central banks compatible with such principles?

The deliberative vision of central bank independence, as articulated by Stiglitz and Rosanvallon among others, has recently been revived by legal and political scientists (Akbik, 2022; Braun, 2021; Downey, 2021; Van't Klooster, 2020). This research is mainly normative, drawing on theoretical reflection on democracy, but it is also based on a sociological and legal critique of the weak parliamentary control exercised by parliaments over central banks in democratic societies. In particular, my criticisms of the pure delegation perspective seem to be very close to those made independently by Brito Bastos and Zeitlin (2020) – based on an analysis of the accountability of banking supervision in Europe – and Dawson and Maricut-Akbik (2021) – based on a positive and normative analysis of the accountability of the

17 I must admit that this claim is a matter of normative interpretation. Friedman and Schwartz (1963) or Bordo (2019), for example, also recognize that historical central bank practices differ from the rule and that central bank actions potentially have very large consequences much beyond price stability. Their policy conclusion however is that societies must limit such consequences by adhering to a narrow and well-defined rule. So our policy conclusions differ although our historical analysis is quite similar. My contention is that rules are necessary but never sufficient, and we must consider the normative consequences of this impossibility.

European monetary union. Both criticize the principle-agent framework as being too narrow and giving an unrealistic view of the balance of power between the delegated authority and the Parliament. Dawson and Maricut-Akbik characterize the principle-agent model (delegation principle) as "procedural accountability" while arguing for more 'substantive accountability', in terms that are very close to what I call here deliberation and reflexivity. Likewise, Britos Bastos and Zeitlin distinguish between two contrasting models of accountability, "one based on principal-agent relations, which is backward-looking, and the other a dynamic and forward-looking model, which we argue is more appropriate to independent institutions operating under high levels of uncertainty." (p. 12).

The common principle of these studies is in line with the argument I developed earlier on the need to institutionalize deliberation (and reflexivity) on monetary policy because the initial delegation is too incomplete to provide full democratic legitimacy. In other words, the confrontation of points of view and the contestation of monetary policy choices must be made possible within an institution outside the central bank, so that the latter is not the only authority responsible for interpreting the authority delegated to it in the face of unforeseen events. The central bank will remain the ultimate decision maker on the use of its instruments (interest rates, lending, asset purchases), but no longer the only one to provide an interpretation of its legal mandate and of the general will.

The principle of *reflexivity* is stronger than the more familiar one of *accountability* discussed earlier. Accountability is key for central bank independence because "it is important to have in place adequate mechanisms to 'guard the guardians' of monetary and financial stability." (Goodhart & Lastra, 2018). Although I agree that accountability should be reinforced in the current context, it is not enough.[18] The insufficiency of accountability is twofold: (i) it is only an ex post control, with no guarantee that the interpretation and different views of others should be really considered and debated; (ii) it says nothing about how the central bank's policy should be coordinated with others.

18 Rosa Lastra has written extensively to make the central bank community aware that accountability is itself much stronger than transparency (and that unfortunately central banks often confound the two): "Accountability is an obligation to give account of, explain, and justify one's actions, while transparency is the degree to which information on such actions is available." (Lastra, 1996, p. 93) I share this view, but I also point out that this definition of responsibility is too formal and procedural if it does not ensure that both parties have an equal capacity to formulate policy scenarios and that the responsible authority must consider alternative scenarios equally when justifying its own action.

6 Credit Policy vs. Monetary Policy

I argue that the difference between the two conceptions of central bank independence described above cuts across two economic conceptions of central bank action: credit policy and monetary policy. Milton Friedman (1969, p. 75) introduced the distinction between credit policy and monetary policy in the following way:

> When I refer to credit policy, I mean the effect of the actions of monetary authorities on rates of interest, terms of lending, the ease with which people can borrow, and conditions in the credit markets. When I refer to monetary policy, I mean the effect of the actions of monetary authorities on the stock of money – on the number of pieces of paper in people's pockets, or the quantity of deposits on the books of banks. Policy makers, and central bankers in particular, have for centuries concentrated on credit policy and paid little attention to monetary policy.

This distinction has been very influential (not only because of Friedman), so that "monetary policy" progressively replaced the term "credit policy" around the 1970s–1980s in the discourse and conceptual framework of central banks (Monnet, 2018).[19] "Credit policy" became a pejorative term denoting excessive intervention of the central bank in the allocation of credit, against the supposed absence of distributive effect of monetary policy. In contrast to Friedman, however, most economists and central bankers came to believe that the interest rate was not a credit allocation tool but a monetary policy tool, as long as it is possible for the central bank to target the "natural" interest rate (Clarida et al., 1999). This is only one example of the conceptual and empirical difficulties to really isolate monetary policy from credit policy. A usual alternative formulation of "monetary policy" – consistent with Friedman's view – is to define it in terms of "neutrality", meaning that the central bank's actions are not supposed to have distributional consequences for the allocation of credit. The claim of market neutrality has a long history in central banking. It is also very relativistic: the instruments perceived as neutral have changed a lot over time (Monnet, 2018, 2021).

The term "credit policy" has quickly reappeared – especially in the United States, and most often with a negative meaning – after the Great Financial Crisis to characterize all the actions taken by the Federal Reserve with deliberate or purported effects on credit allocation. These actions may include targeted rescue lending or large asset purchases that involve substantial changes in central bank portfolio and

19 The Werner report (1971), which was the first major plan for a monetary union in Europe still used the term credit policy and thus equated the integration of monetary policy with the one of credit policy. At the end of the 1980s, the term "credit policy" had disappeared from the plans for a European Monetary Union (see Monnet, 2018, chp. 7).

have massive effect on a range of asset prices.[20] Ricardo Reis (2013, p. 31) summarizes well how – in current debates – the term 'credit policy' has come to characterize those actions of central banks that are seen as undefined in their mandate and therefore raise questions of democratic legitimacy:

> A final objection is that aggressive credit policy exposes the central bank to legitimate political questions of why some firms, markets, or securities were chosen for support and not others.

The distinction between monetary and credit policy is related to the distinction between delegation and deliberation for the following reason. Those who believe that the actions of the central bank can be confined to rule-based monetary policy in a principle-agent framework are likely to exclude credit policy from the central bank's realm. On the contrary, recognizing the distributional effects of central bank actions and their interactions with broader credit policy objectives requires thinking about the legitimacy of central bank policy in this context and thus institutionalizing the coordination of monetary policy with credit policy.

Let me be clear. A deliberative view does not imply that the central bank is in charge of all credit policy and replaces a public investment bank (see below). It recognizes that some monetary policy actions have effects on credit policy and that it is therefore necessary to discuss these effects in a democratic (i.e. not just technocratic) framework and for the parties involved to coordinate their actions. Furthermore, contrary to what proponents of rule-based policy often assert – defending credit policy and deliberation is not the same thing as defending what economists call "discretion," because credit policies can in fact be implemented with an explicit rationale for being consistent with some desired long-term policy outcome (i.e. commitment). This would be the case, for example, for central bank actions to explicitly support green investment financing.

Monetary policy and credit policy are not substitutes. The former is part of the latter. And, in most cases, it is difficult to isolate the first from the second. Recognizing that the central bank is involved in credit policy – rather than only monetary policy – has a fundamental institutional consequence: while it can be argued that the central bank is the only institution in charge of monetary policy, this is not the case for credit policy. Credit policy – in the broadest sense – is not only the domain of the central bank, but involves many other institutions: credit guarantees by the Treasury, agencies responsible for regulating consumer credit, agricultural credit or housing credit, public development banks, etc. It is as important to recognize the specific objective and mission of the central bank (price and financial stability) within the

20 Keeping monetarist ideas alive, Marvin Goodfriend (1994, 2014) had kept producing analysis on this distinction and proposals for reforms. For a review of the use of the term "credit policy" by officials of the Federal Reserve System since 2010, see Sablik (2013).

general credit policy framework as to recognize that the actions of the central banks interact with other dimensions of credit policy.

Credit policy actions by other entities have consequences that cannot be ignored by central banks. For example, Monnet and Vari (2022) demonstrate that the regulation of bank liquidity has effects on the money market and interest rates while Fieldhouse et al. (2018) show that mortgage purchases by government-sponsored agencies in the US have macroeconomic and financial effects rather similar to the one of central banks. With regard to environmental issues, it is now widely recognized that price stability is highly dependent on the consequences of climate change and biodiversity. And the prevention of environmental disasters is itself highly dependent on the ability of government credit policies to support the green transition. Central banks' actions cannot therefore be decided without considering their role in a broader credit policy. But central banks must remain only one actor among others in credit policy, and their interactions with credit policy have strong distributional effects that cannot escape democratic control. Here lie the main challenges. To think that central banks are immune to these difficult questions because they are supposed to have a narrow mandate denies the complex reality of central bank actions and the financial system.

The role of central banks in credit policy has been recently recognized in the debate on macroprudential policies.[21] On the one hand, public policies to regulate credit in order to avoid financial instability are not the sole responsibility of central banks, so these institutions lack the legitimacy and effectiveness to act. On the other hand, central bank actions (including asset purchases and lender of last resort) have consequences for financial stability. Institutional coordination and democratic legitimacy of credit regulation and credit actions are therefore necessary to protect financial stability. These are the reasons why macroprudential councils were created and include central banks as well as political entities (ministry of finance etc.) and officials from other regulatory agencies.[22]

Macroprudential councils however suffer from numerous limitations. First, they are exclusively focused on financial stability. This single objective, due to the post financial crisis context, now already seems outdated as the recent years have emphasized the interactions of central bank actions with public debt management,

21 It is important to note that macroprudential policy is a term that makes sense only in an intellectual and policy framework where credit policy had been disconnected from monetary policy – as it occurred in most OECD countries throughout the 1990s. In many emerging markets, where this distinction had not fully been implemented, central banks were still using credit policy tools (credit ceilings, reserve requirements, liquidity ratios) to influence the price level and credit allocations at the same time. As a consequence, international organizations have relabeled such credit policy tools as "macroprudential tools" in the 2010s. See Monnet, *Controlling Credit*, op.cit, conclusion.

22 For an introduction, see Kelber and Monnet (2014) and Aikman et al. (2019).

fiscal policy and public investment policies (especially for green transition). Second, their role is *de facto* quite limited.[23] They mostly intervene in the regulation of housing credit. This is partly due to the previous limitations, that is their focus on financial stability, which prevents them from taking decisions with important distributive consequences in coordination with other credit policies. Third, their democratic legitimacy has been thought only through the perspective of coordination of existing authorities, but without improvement of parliamentary control nor institutionalized ways for policy-makers or citizens to formulate proposals and take part in the deliberations. In the euro-area, this is related to the fact that the European Systemic Risk Board (ESRB) is only an intergovernmental policy body.

There is thus a need to rethink the institutions of credit policy, and include macroprudential policies in a broader framework. The next section discusses such option, with application to the euro-area context.

7 A European Credit Council

We have become accustomed to the European Central Bank alone producing the interpretation of its mandate (Mudge & Vauchez, 2022). Major debates on the interpretation of the central bank's mandate take place in the Court of Justice of the European Union (CJEU), when it is called upon to rule on a lawsuits against the ECB. The CJEU has so far validated the ECB's policy choices, but it has also called the ECB to order by stating that the ECB has "an obligation to examine, carefully and impartially, all the relevant facts of the case and to give sufficient reasons for its decisions." (De Boer & van't Klooster, 2020; Monnet, 2021).

The European Parliament has a limited role in monitoring the ECB and discussing monetary policy. The ECB submits its annual report to the Parliament once a year and the Parliament can throughout the year summon ECB representatives (the so-called "monetary dialogue" which is quarterly) or address written questions to them.[24] It is interesting that the most important and comprehensive criticism of the ECB policy by the Parliament was formulated (*ex post*) in a report on the ECB role in the *Troïka*. On one hand it shows that the Parliament is not powerless and unequipped. On the other hand, it is telling that this case was not about monetary or credit policy and that the criticisms came too late.

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23 Thiemann et al. (2018). Much ado about nothing? Macro-prudential ideas and the post-crisis regulation of shadow banking. KZfSS Kölner Zeitschrift für Soziologie und Sozialpsychologie, 70(1), 259–286.

24 The Parliament is also consulted on the appointment of the members of the ECB's Executive Board. But the decision is taken by the European Council (i.e. the heads of state or government of the European countries).

Observers of the monetary dialogue make similar observations (see Akbik (2022) for a recent review): it is an *ex post* clarification of the ECB's policy and mostly a formal dialogue to which the ECB can respond in a very general way. Moreover, there is no link between the European dialogue and the dialogues that may take place between the national parliaments and the national central banks of the Eurosystem.

Several proposals have already been made to improve the quality of this dialogue and to strengthen the role of the Parliament. In particular, it has been proposed that a sub-committee of the European Parliament's Committee on Economic and Monetary Affairs be set up to deal exclusively with the dialogue with the ECB, and that the European Parliament and the European Council draw up a list of the main objectives that the ECB should meet each year.[25]

It is important to go further. Studies of deliberation in modern democracies tell us that the quality of deliberation depends on equal access to information, as well as on equal and substantive treatment of different points of view (e.g. Fishkin, 2011). From this perspective, the dialogue between the Eurosystem and the parliament(s) is currently of insufficient quality because of an inequality between the information and expertise available to the central bank and that available to parliament (and more generally to the public). The ECB produces a detailed analysis of the economic situation, financial stability and monetary policy thanks to more than 400 full-time economists. If one adds the economists employed in the various national central banks, this number can be at least doubled and is comparable to that in the United States. In the face of this expertise, the Parliament can only rely on commissioning reports from external economists (not working full time for the institution), usually four for each quarterly dialogue. This institutional imbalance echoes a growing concern among economists about the dominance of research and the production of statistics and analysis within central banks. In addition, the lack of diversity of views is also a problem. The European Parliament's Committee on Economic and Financial Affairs does not have the means to systematically gather views on the ECB from various interest groups, NGOs or countries. The reports that the Parliamentary Committee commissions from experts cannot suffice to give equal voice to different views.

The shortcomings of the dialogue between parliament and the ECB call for the construction of a new institutional framework. It is important to note that the objective is twofold: (i) improve economic policy efficiency through an increase in coordination between the central bank and other political entities; (ii) improve

25 Collective, "The ECB should have a clear political mandate that would make explicit which secondary objectives are most relevant for the EU", *Le Monde*, 9 April 2021. There is also a need for the ECB to improve its transparency, including on potential conflicts of interest.

democratic legitimacy of central bank actions through better deliberation and reflexivity in the policy-making process.

It is tempting to look at the past for solutions, considering the days when central bank intervention in credit allocation and coordination with fiscal policy was the norm. Such a historical comparison is useful but also potentially disappointing. In the three or four decades following WWII (notably in Japan and most European countries during their years of rapid economic growth), central banks faced problems and used instruments that bear many similarities to the current situation. To ensure this coordination, several countries set-up a special organisation, usually labelled as a 'credit council'. The name and form varied from country to country; it was either directly dependent on the central bank or on the government Designed as a response to the market and policy failures of the 1930s, these credit councils were supposed to make the management of money and credit more democratic. But their actual functioning would pale in comparison with today's European democratic standards of governance. They lacked transparency and effective parliamentary control (Monnet, 2018). The lack of transparency of central bank credit policies fueled criticisms of vested interests and inefficiency in the 1970s and 1980s. Therefore, it would be a mistake to revive them without maintaining central bank independence, strengthening parliamentary oversight, and isolating the administration of such bodies from the central bank management.

We thus should think about a framework that offer the Parliament (and more generally the whole of the European legislative and executive powers) an economic expertise equivalent to that of the ECB, enabling it to engage in a structured dialogue on the objectives of monetary policy and the means of achieving them and, above all, on the consequences of the ECB's policy on the other policies of the Union (and therefore the articulation between them).

Several institutional forms are possible. It could be an administration entirely attached to the Parliament, on the model of the *Congressional Budget Office* in the United States, or dependent on the European Commission and the Parliament. Some of the economists currently working at the ECB or in national central banks could shift to this institution. A European Credit Council at the European level would coordinate the various policy actions of the European Union to ensure the financing of its general objectives. In order for monetary policy to support the "protection and improvement of the quality of the environment", it is essential to determine how an ECB lending policy can contribute to the financing of this objective, whether it is necessary for it to do so, and – related to this – how this should be articulated with the environmental financing policies of the other European institutions (European Investment Bank, European Development Fund, European Commission, etc.)

This Council could also give its opinion on the coordination between monetary policy and budgetary policy, or on the status of public debt held by the ECB. It would not be an authority constraining the actions of the ECB, but a place for questioning and making proposals on the articulation between monetary policy, the sustainability of public debt and the financing of the major objectives of the European Union. A key function would be to build alternative policy scenarios in order to make explicit the coordination and interaction between different credit policy actions (including those of the central bank) and discuss whether it supports the general policy of the EU. Thus, the Council is not a decision-making body. It is a tool for the Parliament to assess the legitimacy of the ECB's policy, based on a deliberation on different policy scenarios, presentation of diverse views and an explicit coordination of credit policy.

The ECB would derive the legitimacy of its decisions from the reflexivity and concertation allowed by this Council. In terms of democratic practice, a significant consequence would be to reverse the burden of proof in terms of the priority given to price stability. If a body proposes specific measures to the ECB in support of the EU's general objectives, the ECB will have to respond by explaining the possible contradiction with price stability and the criteria it uses to assess this.

Deliberation would have a significant influence on the decision-making process for many reasons. First, by increasing the information available to citizens and representatives on monetary policy, it changes the terms of the public debate and thus the agenda and the questions to be answered by the ECB (similar to the issues raised by climate change or inequality, which eventually forced central banks to take a stand).

Moreover, by reversing the burden of proof, the deliberation would oblige the ECB to develop arguments and decisions that it would not otherwise have taken. Deliberation can be seen as a step in the subsequent assessment by the CJEU – if necessary – of "the obligation [of the ECB] to examine carefully and impartially all the relevant circumstances of the case and to give adequate reasons for its decisions."[26] Except when it applies to justice itself, impartiality is an entirely relative concept (let alone "carefully"). It is when a real debate takes place, with informed contradictory points of view, and not only during a univocal *ex-post* explanation, that the impartiality and the motivation of a decision can be assessed. A debate in the heart of parliament could avoid that, contrary to what has happened recently, the discussion on the legitimacy of monetary policy is referred to national constitutional courts (De Boer & van't Klooster, 2020). In plain words, the ECB will remain independent because it cannot take instructions, but it will know that its independence rests on its ability to justify (on legal and economic grounds) why its policy is better than other scenarios proposed by the Parliament (based on the deliberations and

26 Case C-62/14, Peter Gauweiler and Others v Deutscher Bundestag, EU:C:2015:400, paragraph 69; Case C-493/17, Heinrich Weiss and Others, EU:C:2018:1000, paragraph 30.

work of the Credit Council). This is what the principle of "reflexivity" means in practice: showing that all potential criticisms and alternatives have been considered before taking decisions. The ECB will internalize that insufficient or biased justifications before the Parliament will be held against it in the event that the European Court of Justice is called upon to decide.

Furthermore, deliberation is a step towards coordination. In the case of monetary policy, coordination with other policies (fiscal, labor environmental, etc.) leads to the setting of a common objective and the establishment of a roadmap to achieve it. This is especially key for credit policy intended to support the green transition.

Let me emphasize again that the central bank will retain full operational autonomy and policy independence in this new institutional framework. For this reason, fears that a Credit Council would reduce central banks' incentives to fight inflation are unfounded. The central bank is not required to seek the approval of Parliament or the Credit Council before raising interest rates, changing asset purchase policy or providing emergency liquidity in times of crisis. But once these decisions are made, the central bank must justify its decisions in the face of several alternative scenarios and different interpretations of its mandate (not only its own). It must also assess the potential interactions of its policy with other economic policies (notably fiscal and credit policies) and consider potential conflicts that should be resolved through explicit coordination.

8 Conclusions

This article has provided a framework for understanding the economic role of central banks and their democratic legitimacy. I argue that thinking about the democratic challenges of central banking requires considering central banks' *insurance* role and how their actions are part of the *credit policy* of the State. The contract between the central bank and the sovereign is incomplete because it cannot integrate all unforeseen contingencies, distributive consequences and interactions with other policies. This opens the door to viewing the legitimacy of central bank decisions through a process of deliberation, coordination and reflexivity, rather than only a delegation of power. I discuss a proposal for a European Credit Council, which would be a deliberative body aimed at strengthening Parliamentary power on monetary and credit policies, the democratic legitimacy of central bank policy in the Euro Area as well as its coordination with other European policies. More coordination, Parliamentary power and deliberation are consistent with central bank independence and aim to delimit more precisely the action of central banks within the macroeconomic and credit policies of the State.

For the sake of brevity, I have discussed here only the general framework and left aside more detailed policy proposals to coordinate monetary and fiscal policies, to create central bank digital currencies, and to strengthen the role of central banking in protecting the natural environment. The book on which this article is based (Monnet, 2021, 2023) discusses this at length and provides a more important historical and conceptual basis for the principles briefly presented here. It also discusses related debates in the United States and other countries, where the legal system and the institutional framework of central banks differ from the European one. Many recent proposals to reform the Federal Reserve, improve the power of Congress in this respect or develop a public investment bank in the US are directly related to the issues I have attempted to shed light on.

It might be useful to conclude that a Credit Council would not in itself be more democratic than the central bank. The aim is neither to add bureaucracy nor to create a hierarchy of institutions, but to strengthen the democratic legitimacy of central bank decisions. It should not be a watchdog of the central bank but should be responsible for discussing potential coordination of policies related to financial and credit issues more generally. This is not the end of central bank independence, but a redefinition aimed at strengthening its legitimacy.

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