The societal responsibility of central banks

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Central banks, and particularly the ECB (European Central Bank), have been constantly criticized since the financial crisis by NGOs (non-governmental organizations), think tanks, and other representatives of civil society for the effects their policies produce in areas that, in principle, do not directly come within the purview of their mandate. Whether it be the redistributive effects of unconventional monetary policies and their impact on wealth inequalities and also financial stability, the differentiated impact of monetary policy on access to jobs according to ethnicity in the United States, the principle of market neutrality seen as an obstacle to the ecological transition, or warding off a sovereign debt crisis in the Eurozone by eliminating the spreads between sovereign bonds, the common denominator of all these subjects is their major impact on socio-economic systems. Hence the need to question the societal responsibility of central banks. And yet, a quick internet search is edifying – this question is completely invisible. The concept does not exist! Or, at least, it is not formulated as such. The only major exception: on May 21, 2021, Isabel Schnabel, a member of the ECB's Executive Board, gave a speech entitled "Societal responsibility and central bank independence".[1] In it, she noted that, "heated public debates about the broader distributional and societal consequences of unconvential policy measures are testimony to the looming distrust facing central banks today". However, as the title of this speech points out, this call for societal responsibility is all the more sensitive and delicate to manage because central banks are independent institutions.

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The societal responsibility of central banks echoes the social responsibility of companies. So why not use the same adjective? Corporate social responsibility is directly tied to the partnership approach of the company, "partners" being those towards whom the company must be responsible. Here the difference in terms expresses the fact that central banks are responsible to society as a whole. This does not mean that central banks don't also have a social responsibility, but that term does not encompass the same expectations as does their societal responsibility. The social responsibility of central banks refers to the way in which the institution deals internally with social issues, parity, ethics, etc. In that case, the evaluation grid is very similar to the one companies may employ. Societal responsibility on the other hand refers to the fact that the central bank manages the currency, a fundamental institution of our socio-economic systems, which immediately places its responsibility at the level of the payment community as a whole.

We shall first attempt to comprehend the forces that are working to undermine the myth of a central bank solely dedicated to preserving the value of the currency and disconnected from major societal stakes and debates. Then we will examine the growing gap between the *de facto* and *de jure* societal responsibilities of central banks since the financial crisis of 2007-2008. We will illustrate this trend towards resetting central bank policy by taking up two heavily debated questions – the effects of monetary policy on inequality and the role of central banks in the ecological transition. Finally, we will indicate the questions that remain unanswered regarding the societal responsibility of central banks.

THE CRUMBLING OF THE MYTH OF SOCIETAL RESPONSIBILITY LIMITED TO PRESERVING THE VALUE OF THE CURRENCY

The institutional form of central bank independence, which became widespread beginning in the 1980s in most of the so-called advanced economies and in many emerging countries, was based on the idea of depoliticizing central banks as a way of lending credibility to the anti-inflationary orientation of monetary policies. Institutionalizing the severing of the tie between governments and the institution in charge of monetary policy was aimed at combating the supposed propensity of governments before elections to pursue too flexible a monetary policy in order to support economic activity and employment – and thus favor their re-election – at the cost of depreciating the currency's value and thus of higher inflation. In economic terms, delegating monetary policy to a conservative central bank (in the sense

of being more anti-inflationary than society, Rogoff, 1985) removes the inflationary bias associated with time inconsistency inherent in monetary policy (Kydland and Prescott, 1977; Barro and Gordon, 1983). The latter is thus seen as a purely technical field that can be delegated to experts entirely lacking in political motivation. This stated "depoliticization" of the currency and of the institution that manages it is reinforced in the Eurozone by the space within which the European currency circulates not coinciding with the space within which a government exercises its sovereignty. The link between currency and sovereign government is weakened because the euro is not backed by a federal budget.

In this very narrow and technicist conception of currency and monetary policy, the societal responsibility of the central bank, even if this formulation was never deemed appropriate, was *de facto* limited to respecting the mandate it had been given, namely, in many countries preserving the value of the currency and thus keeping inflation low and stable. So the assumption was that all of society benefits from price stability – whether debtor or creditor and whatever the social category – contrary to inflation, which was thought to have redistributive effects according to the differentiated capacities of the various economic protagonists to correspondingly increase their revenue. Moreover, most economists thought that financial stability was as good as encapsulated in price stability, which was so-to-speak bundled together with financial stability. In retrospect, this conjecture proved to be wrong. The so-called "great moderation" period from the mid-1980s to the great financial crisis of 2007-2008, marked by low inflation and reduced volatility in both inflation and the business cycle, instead encouraged excessive risk-taking by financial intermediaries, especially banks, without central banks reacting to the excesses of debt and structured financing. From the beginning of the financial crisis, the response of central banks was to reclaim their historical function of lender of last resort and even to go beyond that by becoming the actual market makers of last resort. Central banks saved the global financial system by injecting considerable amounts of liquidity beginning in August 2007 and by substituting for the interbank market, which had been frozen by banks' distrust of each other. It is not so much the bailout that raises questions about the societal responsibility of central banks, but in fact rather not having seen coming the abuses of finance that led to such a serious financial crisis.

It is precisely at this point in time that legitimate questions about the societal responsibility of central banks took root. Central banks were perceived as a kind of firefighting arsonist who had contributed to

creating a macroeconomic context conducive to considerable excess private debt and therefore financial instability. Constricted by their narrow mandate to preserve the value of the currency and trapped in a very pro-market doctrine that dictated their actions, they did not react to the accumulation of financial fragilities in balance sheets, although they assumed the role of savior when the financial crisis broke out. While managing the financial crisis, central banks acted *de facto* in concert with governments to save banks from their excesses. After such an episode, it is hard to continue to view monetary management as simply technical and depoliticized.

All the more so that the following years were marked by revelations of financial scandals of all kinds: the Abacus affair, the Libor, Euribor, and Tibor scandals, which François Morin correctly describes as "organized crime pacts" (Morin, 2015), Ponzi schemes, toxic municipal debts, mortgage fraud, bank involvement in large-scale tax evasion schemes, etc. The list seemed endless. Society thus saw finance only through the prism of its perversions. Expressing popular sentiment, finance in movies is a world of greed, conniving, and conflicts of interest, a world in which profits are privatized and losses mutualized, "heads I win, tails you lose".[2] And central banks are perceived as having been an unwilling part of this environment of generalized moral hazard.

AN UNTENABLE GAP BETWEEN DE JURE AND DE FACTO SOCIETAL RESPONSIBILITY

Everyone has the feeling that since 2007 economic and social life has been ruled by a succession of crises (financial, sovereign debt, health, and ecological). This context has made "visible" what the period of great moderation had concealed: managing the currency is not a purely technical and depoliticized matter. Central banks are key players in world "affairs" and not mere independent agencies oblivious to social needs. Moreover, a glance at history suffices to reject the notion that central banks are institutions immune to the convulsions inherent in crises, wars, and geopolitical tensions.

The first central banks in Europe gave governments financial benefits and assumed the responsibility for managing the public debt.[3] This primary role was often combined with another key role – unifying the issuance and circulation of money, centralizing and managing the country's metal reserves, and thereby improving and fluidifying the payment system. After having been relegated to the back burner, the role of managing public debt was revived in the twentieth century during periods of war and even beyond. Central banking regimes have

therefore continually evolved over the course of history. Goodhart (2010) identifies three stable central banking regimes interrupted by less well-defined times:

– the period he calls the Victorian era, beginning around 1840 and ending in 1914;

– the period of strong government control from the 1930s to the late 1960s;

– and then the era of triumphant markets from the 1980s to 2007.

Despite very different monetary regimes – gold standard in the first period and inflation targeting in the third one – these two periods were characterized by strong confidence in market mechanisms and by central banks that were relatively independent of governments.

After the monetary turmoil of the post-World War I period, however, the end of the gold standard, the Great Depression, and the deflation of the 1930s led to a central banking regime in which central banks found themselves in a position of relative subordination to governments that were more intrusive and authoritarian towards banks and finance. The retaking of control was justified by the fact that part of public opinion suspected central banks of being beholden to the interests of private financiers and of neglecting the public interest (Crockett, 2003). Governments gained the upper hand over central banks fairly rapidly, and in many countries this took the form of nationalizing the central bank (Singleton, 2010; Blancheton, 2016). The public central bank model then spread throughout Europe and the rest of the world in the 1940s.

This periodization suggests that since the financial crisis and the great recession we have entered a transitional period towards a new central banking regime in which central banks will again ground their policy in publicly debated questions.

The financial crisis has unveiled, in the literal sense of having lifted the veil, the absence of neutrality in how central banks, including the most independent ones, manage the currency. This is especially the case of the ECB. There is a discrepancy between the *de jure* societal responsibility imposed by an often narrow mandate that boils down to ensuring a stable monetary environment and the established reality of a greater *de facto* societal responsibility. The fact that this discrepancy is now being highlighted lies behind increasing demands from the public that this state of affairs at last be recognized.

Indeed, since the crisis of 2007-2008, episodes have increased in which central banks and especially the ECB have taken on a role viewed as having a major socio-economic impact. Wasn't it Mario Draghi's "whatever it takes" that saved the euro while member states kept

hesitating on how to act? From this point of view, hasn't the ECB *de facto* taken on societal, and even political, responsibilities, overstepping its narrow responsibility of preserving the value of the currency? When the ECB "closes" the spreads between member states' sovereign debt rates, thereby averting the specter of a new sovereign debt crisis, isn't it *de facto* resuming its historical role of managing public debt?

This collective realization of the fact that central bank powers extend far beyond their official mandate has fueled the many calls from civil society for them to more directly mobilize their capacity for action benefitting the common good.

THE RECOGNITION BY CENTRAL BANKS OF THE REDISTRIBUTIVE EFFECTS OF MONETARY POLICY

In the United States, the pandemic has revived a debate on the role of the US central bank in relation to racial inequalities in access to jobs. The Fed's dual mandate is rooted in the US social movement for equal rights. After having won civil rights, Martin Luther King's ambition was to broaden out his activities to the issues of inequality and full employment. Upon his assassination, his widow Coretta Scott King took up the cause, co-founding the National Committee for Full Employment, which played a key role in the discussions leading up to the Humphrey-Hawkins Act of 1978 establishing the Fed's dual mandate – controlling inflation, but also aiming for maximum employment. This second goal quickly took a back seat in the context of high inflation, which led to the appointment of Paul Volker as head of the Fed in 1979. But it enjoyed a return to favor during the Great Recession and the financial crisis of 2008, when the Fed chose to support the economy until the unemployment rate dropped to 3.5% (to 5.4% for African-Americans) at the end of 2019, the lowest level in forty years (Goetzmann, 2020). Since the pandemic and lockdowns effaced this result, the issue has returned with a vengeance. Consequently, in July 2020 Jerome Powell admitted to paying a lot of attention to the unemployment rate for all categories of the population, while deeming that the central bank did not have the tools to fight against racial inequalities, which require budgetary tools. Nevertheless, one month later, in a speech at the Jackson Hole Symposium, he announced that the Fed would give more weight to its mission to promote employment for low-income families, the ones most affected by the pandemic. This is one of the major reasons given for revising the US central bank doctrine, according to which the goal of price stability from now on means a rate of inflation close to an average 2% in the medium or long term. Accordingly, actual inflation may remain above this target for some time, as long as that compensates for an earlier

period when inflation was below the target. The goal of full employment – including for the African-American and Hispanic minorities – is thus once again becoming a priority, which is reflected in the fact that the Fed is monitoring new indicators to adjust its monetary policy, including the unemployment rate of African-Americans and wage growth for the lowest-paid workers.

The growing attention paid to the effects of monetary policy on inequality is not exclusive to the Fed. The issue is also beginning to be discussed at the ECB. This is evidenced by Isabel Schnabel's speech on November 9, 2021, entitled "Monetary Policy and Inequality".[4] Noting that the pandemic has exacerbated the perception of growing inequality, she argues that, "central banks are no longer considered bystanders in this discussion. The use of asset purchases, in particular, has triggered concerns that monetary policy may raise economic inequality by favoring those who own financial assets". According to Isabel Schnabel, this diagnosis must be qualified. Noting that lower-income workers are also more exposed on average than higher-income workers to the risk of job loss in a recession, she concludes that the positive effect of expansionary monetary policy, through its effect on GDP growth, benefits mainly the lowest-income social groups. In the last analysis, according to Schnabel, the response of central banks to the financial crisis of 2007-2009 therefore protected above all the most vulnerable and underprivileged members of society.

URGENT CALLS FOR GREENER MONETARY POLICY

Central banks have also been subject to pressure and demands from civil society regarding their inaction on the climate front. The pressure to act can be explained by the vicious circle linking finance and climate. By providing inexpensive and abundant financing, whose risks are inadequately assessed, to companies involved in fossil fuel research, exploration, and production, financial institutions make climate change possible and even accelerate it. Moreover, climate change is a major factor of financial instability. The real goal of the ecological transition is to drastically reduce our GHG (greenhouse gas) emissions below a critical threshold, called the planet's carbon budget. This is the maximum amount of hydrocarbons that can still be burned while remaining below the +1.5 °C warming threshold. In order to respect a carbon budget of +1.5 °C with a 50% probability by 2050, nearly 60% of fossil oil and methane (the main component of natural gas) and 90% of coal must not be extracted (Welsby *et al.*, 2021). Some of these reserves that cannot be burned have already been prospected and already figure on mining industry balance sheets. The stranding of these fossil-based assets is therefore unavoidable, even if it is hard to

know precisely when that will happen. However, strictly speaking, markets and financial intermediaries are incapable of functioning under the obligation of respecting the carbon budget. Pure financial analysis leads to judging investment projects and choosing between them on the basis of criteria that remain totally impervious to global warming and more generally to any degradation of ecosystems. Finance allocates financial flows according to the expected risk/return ratio, which does not take into account the negative externalities of brown investments (over-investing due to the underestimation of the risk of stranding), nor the positive externalities of green investments (under-investment in relation to what would be socially optimal). Consequently, the only way to bring about a reallocation of financial flows in favor of sustainable and ecologically tenable investments is strong intervention by public authorities, regulators, and central banks to modify the expected risk/return ratio in favor of "green" investments, to the detriment of carbon-related investments. By adapting their instruments, central banks have the means to bring pressure to bear on market mechanisms and break the vicious circle by encouraging the reallocation of financial flows and the revaluation of financial climate risks. This explains why they are being called out on this question.

However, taking on this responsibility remains a sensitive issue, because global warming creates a situation of radical uncertainty. Statistical tools here become ineffective since past patterns can no longer guide our actions. Yet our economic systems are founded on governance that is based on quantification, especially of the cost-benefit ratio of economic policy measures. Making decisions in a situation of radical uncertainty implies accepting innovative methodologies that are more forward-looking, more qualitative, and more analytical, abandoning probabilistic approaches. The difficulty of discarding the dogma of precise and systematic quantification as a justification for public action creates a "bias in favor of inaction". One is struck by this when reading reports from the NGFS (Network for Greening the Financial System), whose analysis is very clear-sighted but which, despite recognizing the urgency of acting, continue to call for more research on the grounds for action. They recognize nevertheless that, by definition, this quest for the Holy Grail cannot succeed in a situation of radical uncertainty. Yet we know that the least tenth of a degree counts in our collective fight against global warming. Hence the demands from civil society on central banks, which have several levers at their disposal for greening their monetary and macroprudential policies as long as they accept a paradigm shift in the motives behind their actions. Without claiming this list to be exhaustive, central banks

could green their collateral policy, require "green" prerequisites for privileged access to liquidity, green QE (quantitative easing), coordinate with public investment banks to support investment plans for the ecological transition, and even monetize public debt in order to create room in the budget to ensure economies make the ecological shift. They don't do this, or do very little of it, in the so-called advanced countries. The bias in favor of inaction is reinforced by their independent status and the lack of democratic legitimacy for climate action behind which they hide. And yet arguments such as systemic financial risks due to climate change and the impact of global warming on inflation plead in favor of central bank action.

PROGRESS, BUT MORE NEEDS TO BE DONE

The focus put on the redistributive effects of monetary policy and the role of central banks in the ecological transition should not overshadow the fact that the institutional framework in which they forge their doctrine and their monetary policy has a major influence on the way they respond to their societal responsibility. It is particularly important to look at the players with whom they have formed regular and institutionalized contacts and who are therefore likely to influence the way they exercise their societal responsibility. As part of its strategic reviews, the ECB has thus displayed a desire for transparency and has organized "unfiltered" exchanges with NGOs (Positive Money, Finance Watch, Greenpeace, and so on), which have sometimes challenged its positions in a fundamental way (ECB Listens, 21 October 2020).[5] It has also circulated a questionnaire making it possible for European citizens to comment on its actions.[6] The transcription of responses by participants has been remarkably transparent, both with regard to the answers on inequality (question on secondary goals) and those on the climate. This more "open" approach to society's expectations is in line with the ECB's societal responsibility. This commendable effort during the strategic review exercise should nevertheless not serve to obscure the fact that much less "evenly balanced" channels of influence continue to be quite active. For example, in October 2017, the Corporate Europe Observatory published a report revealing the composition of the ECB's advisory committees (CEO, 2017). On the date of the report, it noted the existence of 22 advisory committees comprised of 517 members, among which 508 were representatives of the private financial sector (banks, asset managers, clearing houses, financial advisers, and so on). Within these committees, European systemic banks were overrepresented, with 208 seats out of the 508 cornered by the finance industry. This quite lopsided composition of the ECB's advisory committees, systematically favoring financial ope

rators, contravenes its societal responsibility because it does not reflect the diversity of interests. Since the selection of these committees is rarely based on open calls for candidates, the ECB engages its societal responsibility by not opening up the deliberative bodies of the ecosystem that influences its decisions.

CONCLUSION

As Monnet (2021) rightly reminds us, "central banks as we know them today (i.e. public institutions, not subject to the profit motives of private shareholders) were born at the same time as the welfare state, and with similar goals, at the end of the Second World War (p. 9)" and, "as a 'welfare bank', the central bank must be made part of democratic debates and institutions, and not be a purely technical manager dealing with subjects isolated from the rest of economic and social policy (p. 8)". The embedding of the central bank in the welfare state system has been masked by the illusion of currency neutrality and the purely technical way it has been managed, illusion which dominated the central banking model that had become the norm before the financial crisis. The current animated debates on the various aspects of the societal responsibility of central banks explicitly revive the notion of a central bank anchored in society, protecting against the excesses and failures of the financial markets, reducing uncertainty and coordinating with governments in order to ensure a stable macroeconomic and macrofinancial framework.

NOTES

1. See the website: https://www.bis.org/review/r210528e.pdf.

2. See fictional accounts, such as "Margin Call", "The Wolf of Wall Street", or "The Big Short", a fictional documentary, as is "Cleveland vs. Wall Street", or the incisive documentary "Inside Job", which begins by saying, "The 2008 meltdown was avoidable."

3. The first central bank, the Riksbank, was founded in 1668 to finance the Swedish government's wartime expenses. As for the Bank of England, it was created in 1694 to facilitate financing the public debt created by the war led by William III against James II and Louis XIV.

4. See the website https://www.ecb.europa.eu/press/key/date/2021/html/ecb.sp211109_2~cca25b0a68.en.html.

5. See the website https://www.youtube.com/watch?v=GclTry1FGIA.

6. See the website https://www.ecb.europa.eu/home/search/review/html/ecb.strategyreview002.en.html.

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