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Central Banking in Contemporary Capitalism: Inflation Targeting and Financial Crises

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Abstract

This paper examines central banking in contemporary capitalism, particularly the role of inflation targeting and central bank independence. Emphasis is laid on the consequences of financial instability in light of the various episodes of the 1990s as well as the current sub-prime mortgage market crisis. A Marxist political economy framework of monetary policy and financial instability is employed to show the limits of contemporary monetary policy. The paper stresses the importance of the various social and political aspects of central banking and their relation to class interests. It is established that the recent financial crisis shows the class dimension of inflation targeting, particularly its defence of financial interests. Central banks have used their power to protect financial profits while socialising financial losses at the expense of the vast majority of society.

1. Introduction

Financialisation is the result of the transformation of real accumulation in recent years, which has also led to the transformation of the financial system. Real accumulation witnessed a regime shift in 1973-74, during the so-called first oil shock that signalled the end of the long post WW II boom. This regime shift was accompanied by a profound institutional and political reaction as a response to the failure of official Keynesianism to deal with the stagflationary crises of the 1970s. The recent wave of financial globalisation started in the mid-1980s, with rising cross-border financial flows among industrial economies and between industrial and developing economies. This has in turn promoted financial innovation, such as the introduction of increasingly sophisticated financial assets and the growth of new financial players.

Against this background the financial sector has been entirely transformed through rapid growth, deregulation, global expansion, introduction of new technology, institutional change and financial innovation. The weight of the financial sector has grown markedly in developed countries in terms of employment, profits, size of institutions and markets. Finance now penetrates every aspect of society in developed countries, and is becoming increasingly important in the developing world (Lapavistas, 2009).

However, with the surge in financial flows came a spate of currency and financial crises in the late 1980s and 1990s. The importance of the central bank has increased as bubbles and financial crises have become a regular feature of financialised capitalism, particularly since their nature has varied significantly from the turmoil of the mid-70s due to the transformation of the financial system. Nevertheless, much ambiguity and confusion surrounds the operations of the central bank in the new environment, even as it aims to preserve the interests and social dominance of the capitalist class.

A first response to these trends by economic policymakers was to strengthen the monopoly of the central bank over legal tender. The financial system became even more dependent on using central bank money as obligatory means of payment for the settlement of debts. At the same time, inflation targeting and central bank independence were also adopted.¹ Since the early 1990s inflation targeting has become the dominant ('best practice') monetary policy paradigm in several high- and middle-income countries.² In addition to countries that follow fully-fledged inflation targeting policies, several dozen countries have adopted it informally or implicitly, for example, by pursuing 'inflation caps' (maximum desired inflation rates) in the context of IMF programmes. Such 'caps' are insufficient to define these policy regimes as inflation targeting, but they are evidence of a medium-term move towards inflation targeting.

Moreover, the macroeconomic performance of most OECD countries improved in terms of inflation, unemployment, output volatility and interest rates during the last ten to fifteen years. This is the so-called 'Great Moderation', which has been attributed by mainstream theorists to neo-liberal policies. In this context, monetary policy has become even more prominent, further strengthening the tendency towards adopting inflation targeting (Bernanke, 2004).

¹ On how the central banks have strengthened their monopoly of legal tender in the era of financialisation, see Kneeshaw, J.T. and Van den Bergh 1989.

² The following countries are full-fledged inflation-targeters: Australia, Brazil, Canada, Chile, Colombia, Czech Republic, Hungary, Iceland, Israel, Mexico, New Zealand, Norway, Peru, Philippines, Poland, South Africa, Republic of Korea, Sweden, Thailand and the United Kingdom (see Carare and Stone 2003 and Stone and Bhundia 2004).

This paper discusses these developments by adopting a Marxist approach which stresses the social and political aspects of central banking and their relation to class interests. It is shown that the current financial crisis has also become a crisis of the monetary policy regime, while revealing the class dimension of inflation targeting. Essentially, inflation targeting has been an attempt to preserve financial interests at the expense of the vast majority of society. The same underlying aims characterise recent mainstream proposals to move central bank policy beyond inflation targeting. Devised partly in response to the current crisis, these proposals stress the central bank's function as lender of last resort and complement it by the novel function of 'market-maker of last resort'. Such policies aim at using the power of the central bank to socialise financial losses while defending private profits.

The paper first analyses the inflation targeting framework while advancing a political economy critique of mainstream views of inflationary phenomena. It then analyses the social relations characteristic of central banking by adopting a Marxist approach. Specifically, the theory of central banking as "contested terrain" of class and intra-class conflict is subjected to critical analysis. Further, capital/labour and finance/industry relations are examined in light of developments in the era of financialisation under the neo-liberal agenda. Finally, financialisation is analysed with regard to financial bubbles, establishing connections between bubble-bursting and sudden changes in monetary policy, while demonstrating the relation of monetary policy changes to social and political interests.

2. The Rise and Fall of Inflation Targeting

2.1 The trajectory and effectiveness of inflation targeting

Inflation targeting has been the dominant, 'best practice' monetary policy paradigm for nearly two decades and until the emergence of the subprime mortgage crisis. Things have now changed and several policymakers and economists argue that central banks must move beyond inflation targeting.

Early indications of the demise of inflation targeting can also be detected in the previous period. Thus, until the Asian crisis of 1997-8, inflation targeting was implemented in its original form, the primary focus of which was price stability. However, after the financial crises of the 1990s, financial stability began to be considered as a goal for monetary policy of equal, if not greater, importance to price stability. This contributed to a gradual weakening of the exclusive focus towards price stability (Siklos, 2002, p.8). This gradual weakening of the primary focus on price stability has encouraged a theoretical critique of inflation targeting, which has supplemented older empirical critiques of its effectiveness.

Problems for inflation targeting appeared already in the early period of its implementation, when conflicting conclusions came out of efforts empirically to measure its effectiveness. Several studies identified presumed gains regarding the rate, volatility and inertia of inflation, improved expectations, faster absorption of adverse shocks, lower sacrifice ratio (the output cost of reducing inflation), output stabilisation, and convergence of poorly performing towards well performing countries.³ However, other studies were more critical of the effectiveness of inflation targeting. They claimed that there is no convincing evidence that inflation targeting improves economic performance as measured by the behaviour of

³ See, for example, Bernanke, B.S. and M. Gertler 1999a, Debelle, G. Masson, P. Savastano, M. Sharma S 1998, Mishkin and Schmitt-Hebbel 2001.

inflation, output or interest rates, and it may even lead to a deterioration of some indicators, especially unemployment.⁴

These conflicting conclusions are partly due to the different approaches and econometric methodologies used in various studies. Yet, the divergence of assessment is also due to deeper reasons. There are strong indications that the performance of most OECD countries has improved in terms of inflation, unemployment, output volatility and interest rates during the last ten to fifteen years. These improvements are evident in both inflation targeting and non-inflation targeting countries, which suggests that the underlying cause is something other than inflation targeting.

In the words of Arestis and Sawyer (2006, p.24): “Both inflation targeting and non-inflation targeting countries performed over the inflation targeting period equally well. The average rate of inflation and its variance have been reduced in both periods. This is true for both inflation targeting and non- inflation targeting countries ... We may conclude ... by suggesting that on the basis of the average inflation and GDP growth rates performance, there is not much difference between inflation targeting and non- inflation targeting countries ... Consequently, inflation targeting has been a great deal of fuss about really very little!”

2.2 The framework of inflation targeting

According to its advocates, “fully-fledged” inflation targeting consists of five components: absence of other nominal anchors for the economy, such as exchange rates or nominal GDP; no fiscal dominance; policy (instrument) independence; policy transparency and policy accountability.⁵ In practical terms, the central bank announces that it will strive to hold inflation within a specified target range - rather than a plain number - typically established for horizons between one and four years. “Price stability” is usually defined as 2% inflation (Bernanke and Mishkin, 1997, p.99).

The degree to which the central bank is formally accountable for meeting this target varies. In New Zealand, for example, the law links the tenure of the central bank governor to the inflation target whereas in other countries there are no legal or explicit sanctions. At the institutional level, inflation targeting is usually associated with changes in the law, which enhance the independence of the central bank from the elected government.⁶ Some economists draw a distinction between goal independence and instrument independence (DeBelle, Guy, and Stanley Fisher, 1996). This distinction may not mean very much in practice because the two kinds of independence are complementary – enhancing one kind of independence necessarily implies enhancing the other (Bernanke and Mishkin, 1997, p.102).

Advocates of inflation targeting insist that, at the level of the government, the policy institutionalises ‘good’ (i.e., orthodox) monetary policies, while increasing the transparency and accountability of the central bank and providing guidelines for other government policies.⁷ Apparently, inflation targeting also helps to shape private sector expectations,

⁴ See, for example, Agenor 2001, Cecchetti and Ehrmann 1999, Chang and Grabel 2004, pp.183-4, and Neuman and von Hagen 2002, pp. 149-153.

⁵ See Mishkin and Schmidt-Hebbel, 2001, p.3; Bernanke, Ben S., Thomas Laubach, Adam S. Posen and Frederic S. Mishkin 1999.

⁶ Bernanke and Mishkin, 1997, p.102; Mishkin and Schmidt-Hebbel, 2001, p.8.

⁷ See however, Aybar S and Harris, L (1998, pp. 20-38) for a critique from a radical political economy perspective.

thereby reducing uncertainty and the costs associated with the necessary adjustment to the new, low inflation regime. The implication is that other economic policy objectives – such as employment generation, economic growth and income distribution – should be subordinated to inflation targeting. Inflation targeting, therefore, came to dominate all economic policymaking for nearly two decades. It reinforced the neoliberal view that government intervention in the economy is either useless or counterproductive, and that inflation is largely due to fiscal deficits, adverse expectations and lack of policy credibility.

It is worth examining a little more closely the economic model that underpins inflation targeting. The model is very simple and includes two key parameters: the inflation target and expectations of inflation. The former is set by the government, while the latter arise from the private sector. The model also includes one discretionary policy instrument: the nominal interest rate. In this light, the main objective of the central bank is to eliminate the difference between the rate of inflation and the inflation target at some point in the future (the ‘policy horizon’, usually set at between one and three years).

The model presumes that inflation is jointly determined by the inflation expectations of the private (mainly financial) sector and the output gap, explained below. The rate of unemployment presumably fluctuates around the NAIRU: when unemployment is below (above) the NAIRU, it leads to higher (lower) inflation.⁸ The output gap (expressed as the difference between the current rate of unemployment and the NAIRU) is determined by the level of real interest rates. High real interest rates raise the output gap, while low interest rates stimulate economic activity and reduce the gap. Finally, the real interest rate is, by definition equal to the nominal interest rate minus inflation expectations. The central bank attempts to hit the inflation target by manipulating the nominal interest rate in order to influence expectations and, at a further remove, fine tune the level of aggregate demand.

It follows that inflation control demands ‘credible’ macroeconomic policies, which in essence means adopting the “orthodox” policy view. It also follows that monetary policy discretion should be used within a tight framework of rules. Furthermore, there should be liberalisation of the capital account and elimination of residual inflationary pressures through import liberalisation. It goes without saying that direct and indirect wage restrictions should also be removed. Finally, when inflation targeting is implemented by independent central banks, it is supposed to ‘discipline the politicians’ by removing the inflation bias that they are supposed to generate due to elections.

Thus, the model and its policy implications are based on two underlying claims. First, that persistent unemployment is essentially voluntary (natural), since involuntary (true) unemployment is a transitory phenomenon. Second, that attempts to lower unemployment below its ‘natural’ rate will trigger inflation, and perhaps even create accelerating inflation. In short, inflation targeting is based on the notion that there is an empirical trade-off between inflation and unemployment. Yet, there is little evidence that this is true.

Drawing on empirical evidence, Shaikh (1997) has made three points to the contrary. First, for much of the post-war period, the rise in average unemployment levels in OECD countries was directly associated with a fall in average output growth rates. Second, there is no general historical trade-off between unemployment and inflation in OECD countries.

⁸ The NAIRU (non-accelerating inflation rate of unemployment) derives from the monetarist concept of the ‘natural rate of unemployment’ (NRU). The NRU is the unemployment rate at which all markets, including the labour market, are in equilibrium. The NAIRU is defined as the unemployment rate compatible with stable inflation in the long-run (if the economy is operating below the NAIRU, inflation will presumably accelerate and vice versa).

Such a trade-off might have existed during 1975-1991, but the very opposite pattern seems to hold for the period 1964-1974. Third, inflation appears to be related to economic growth, namely lower growth is associated with higher inflation.

Shaikh's Marxist critique is consistent with the views of other authors within Marxist political economy.⁹ Inflationary trends exhibit little homogeneity within capitalist economies, and are often associated with processes that the state cannot immediately and effectively control. A fuller understanding of both inflation and inflation targeting from a Marxist perspective, therefore, requires placing these phenomena within a specific social and historical context.

3. Central banking and class interests

3.1 *The historical context of inflation targeting*

The regime of inflation targeting is a product of historical development. After the collapse of the Bretton Woods system in the early 1970s the ability of the main central banks to exercise discretionary power over the rate of interest increased greatly. Monetary policy started to acquire its present historical significance because of the attenuation, or complete absence, of foreign exchange reserve discipline on the central banks. The rate of interest has acquired the character of an instrument of public policy, and a multitude of often contradictory demands has been placed on central banks regarding interest rate manipulation. Typically these demands have included price stability, a satisfactory level of economic activity and a balance of payments outlook compatible with high growth and employment. However, the absence of gold discipline, after the collapse of the Bretton-Woods system, only served to emphasise the anarchical nature of the international capitalist system by encouraging exchange rate instability, price inflation and financial speculation.

The collapse of the Keynesian ideology of full-employment and the emergence of rapid inflation in the 1970s gradually made price stability the primary objective of monetary policy. Thus, Dumenil (2007, p.7) notes that the structural crisis of capitalism, beginning in the 1970s, created the conditions for the reassertion of the hegemony of finance. The rise of finance was combined with a broad set of other practices: deregulation, direct confrontation with the worker movement and unions, a policy favourable to large mergers, and new methods of corporate governance favourable to the interests of shareholders. For Dumenil, neoliberalism is a new phase of capitalism, also signalling the return of finance to hegemony.

The state has played an instrumental role during these transformations. Historically there have been two primary and one secondary function of the state in relation to capital accumulation. The primary functions are, first, securing the labour system and, second, securing the money system. The secondary function is mediating the contradictory interests of different parts of capital. The primary functions are critical to accumulation but cannot be guaranteed by capital itself (De Brunhoff, 1976). The necessity of the state to secure the labour and the money system is due to the very nature of capitalism. On the other hand, the state's mediating role derives historically from the anarchy of market-based interactions.¹⁰

⁹ See A. Saad-Filho (2000), A. Saad-Filho and M.R. Mollo (2002)

¹⁰ Marx's first mention of the state in *Capital* is in relation to the production and distribution of coin, which is "an attribute proper to the state". The same point is made in relation to paper currency (Marx 1976, p. 223, 227)

As a state (or semi-state) institution, the central bank has varied greatly throughout history depending on the structure of the financial system, its connections with real accumulation, the social and political relations mediated by finance, and the past practice of interventions. The role of the central bank during the Bretton Woods era, for example, was the historical result of the great depression of the 1930s as well as the emergence of the Keynesian ideology of full employment. In the period of neoliberalism, which signalled the reassertion of the power of finance, the major event was the change of monetary policy in 1979, targeting monetary policy overwhelmingly toward price stability. The Volcker coup in the USA took place primarily because of the experience of the stagflationary period of the 1970s (Mayer, 2003), and eventually led to the triumph of inflation targeting.

3.2 Central banking and the management of modern money

Since the collapse of the Bretton Woods system, contemporary money has become overwhelmingly credit money resting on central bank money (banknotes and deposits) which is in turn backed primarily by state instruments of debt. Central banks have been freed from the need to guard their gold reserves. Consequently, they have acquired fuller discretion in making loans, in issuing their own money and, above all, in determining interest rates. Under these conditions, stability of the value of central bank money has come to depend on two factors: first, on the central bank's management of aggregate credit flows and, second, on central bank money being legal tender for the settlement of commercial and other debts.

The central bank's monopoly over legal tender is a fundamental component of contemporary finance. Modern central bank money (banknotes and deposits) functions as obligatory means of payments, backed mostly by state debt. Consequently, it has clear aspects of fiat money, that is, money with arbitrary circulation backed by the power of the state. Nevertheless, modern central bank money is still issued by a bank, in other words, it is fiat money that has mutated out of credit money. The management of modern fiat money draws on the social power and trust invested in the central bank. In this light, central bank management of modern credit money - a continuous evolving process - can be seen primarily as an effort to preserve the value of credit money.

3.3 Central banking as "contested terrain" of class and intra-class conflict.

The Marxist approach proposed here has common features with radical post-Keynesian treatments of central banking. Post-Keynesian economics pays particular attention to conflicting interests and especially to class and intra-class struggles as determinants of central banking. Central banking is seen as "contested terrain" in economy and society.¹¹ Four key factors determine monetary policy, namely the structure of the labour market, connections between finance and industry, the position of the national economy in the world economy, and the position of the central bank in the state apparatus.

However, the interpretation of financialisation underpinning this article also differs significantly from the post-Keynesian analysis. Differences are pronounced with regard to the structure of the financialised labour markets as well as the connections between finance and industry and their effect on monetary policy. Contrary to post-Keynesian analysis, the central bank is primarily a defender of financial interests rather than 'contested terrain. This

¹¹ See Epstein and Schor (1986, 1988, 1989, 1990), and Epstein (1992).

approach sheds necessary light on the various crises during the era of financialisation, including that of 2007-9.

To be more specific, with regard to relations between capital and labour, Epstein (1992) distinguishes between what he calls the “Kaleckian” and the “neo-Marxian” approach.¹² The latter posits a negative relationship between employment, capacity utilisation and profit shares. As the economy expands and unemployment falls, workers gain the power to raise real wages, or to improve working conditions, with the result of lowering productivity. Thus, as capacity utilisation increases, unit labour costs increase and industrial profit share falls. In contrast, the “Kaleckian” approach suggests that increased capacity utilisation reduces competition and gives firms market power, thus allowing firms to increase their mark-ups. Consequently, industrial profit share rises as capacity utilisation increases or, at worst, remains constant. Thus, the “Kaleckian” labour market postulates a non-negative relation between employment, capacity utilisation and profit share.

It is notable that neither of these approaches sheds much light on labour markets in the current regime of financialisation. Ultimately this is because Epstein (1992, p.7) defines the structural characteristics of labour markets by focusing on a very narrow aspect of the capital-labour relationship, namely the effect of changes in capacity utilisation (and thus of the “reserve army” of the unemployed) on capital’s profit share. But the structure of contemporary “financialised” labour markets has been determined partly by technological change, partly by regulatory change, and partly by bouts of unemployment at key junctures of the period of financialisation.

In the course of financialisation, as Lapavitsas (2009) notes, there has been a rebalancing of paid and unpaid labour, while information technology has encouraged the contraction of private time as well as piece work and putting out practices. These changes have effectively led to an increase in the working day. Moreover, it is also likely that labour has been intensified. From the extensive literature on job satisfaction, for instance, it transpires that work intensification associated with new technology is a key reason for dissatisfaction with work in developed countries, together with loss of discretion over work choices counting for a deterioration of their living standards. Finally, the process of work has also been critically affected by institutional changes in the labour market. This includes casualisation of labour and entry of women in the labour force which effectively increased the working population. Thus, the fluidity of labour has increased at the cost of greater insecurity of workers.

In this environment it is hard to advocate either a “neo-Marxian” or a “Kaleckian” relationship between employment and capacity utilisation. Rather, new technology has intensified competition even among firms which previously possessed significant market power. In “financialised” labour markets, employment is positively associated with profit rates, while being institutionally dissociated from the wage level.

Furthermore, post-Keynesian analysis of the relationship between finance and industry under current conditions suggests that finance holds a dominant position relative to industry.¹³ The reason is, presumably, that financial institutions have the ability to continue making profits even when real accumulation meets difficulties. As a result, in the current regime of capitalist accumulation, finance plays a pivotal role in promoting capital

¹² Neo-Marxism includes authors such as, Boddy & Crotty 1975; Schor 1985; Goldstein 1986; Schor and Bowles 1987; Weisskopf 1988; Bowles and Boyer 1989; Bowles, Gordon, and Weisskopf, 1989.

¹³ Very selectively, see Stockhammer 2002, 2007, Orhangazi 2007

accumulation as a whole. However, this is a problematic view. In spite of its rising relative autonomy, finance continues to comply broadly with the essential motion of capitalist accumulation because its objective foundations continue to be found in idle money generated by capitalist enterprises.

The importance of this point can also be seen in connection with the “contested terrain” approach. According to that, the primary concern of the central bank is to keep monetary policy out of the hands of labour. But it is also argued that, when industrial and financial capitalists are strongly divided, central bank independence often serves to keep monetary policy out of the hands of industrial capital. In this case, the central bank tends disproportionately to favour financial, or ‘rentier, interests.¹⁴ This means that there is space for political alliances between labour and the industrial fraction of the capitalist class to defeat the financial fraction.

It is important to note that Epstein (2002, p.17) has recently argued that: “There seems to be further evolution in these class interests. Increasingly, in the United States and, probably Europe, rentier and industrial interests may be merging, but not as in the case of old German and Japanese financial structures (Zysman, 1984; Pollin, 1995; Grabel, 1997) where industrial interests dominate finance. Rather, it may increasingly be the case that with the deregulation of financial markets - that is, with financialisation - industrial enterprises themselves are beginning to be increasingly guided by rentier motives. In short, “financialisation” may have changed the structure of class relations between industry and finance, making their interests much more similar”

In this connection, Marxist work shows that the foundations of the “contested terrain” are flawed and the analysis has to be reconsidered (Lapavitsas, 1997a, pp. 85-106). First, it implies the existence of pure ‘functioning’ capitalists who possess investment projects but no money. This is an ideally abstract assumption: In practice borrowing capitalists typically possess some of their own capital plus some that they borrow. Second, revenue in the form of interest tends also to accrue to industrial and commercial capitalists, and it is not the exclusive foundation of a separate social group, such as financial capitalists. The separate and often opposing interests of lending and borrowing capitalists cannot be fully analysed in terms of the functioning-industrial section of the capitalist class confronting the financial-moned section.

Lapavitsas (2009) makes further relevant observations regarding the characteristics of contemporary rentiers in financialised capitalism. These confirm the view that revenue in the form of interest tends to accrue to industrial and commercial capitalists and cannot be the exclusive foundation of a social group. Rentiers in the era of financialisation are able to draw extraordinary incomes because of their position relative to the financial system, and not through ownership of financial capital. It follows that financialisation ought to be approached by treating the financial system as a structured whole that is connected organically to real accumulation. The recent ascendancy of finance has systemic origins. Its social outcomes are far more complex than rentiers squeezing industrialists. By the same token, there is no reason for labour to support industry against finance.

To recap, financial institutions have continued to make profits despite the problems faced by real accumulation during the period of financialisation. Consequently, the significance of the financial system has increased enormously, since under such conditions finance has become a source of profits for the capitalist class as a whole. Meanwhile, capital-labour

¹⁴ See Epstein and Ferguson 1984, pp. 957-983; Epstein 1992, pp. 1-30.

relations have been rebalanced with an eye to keeping central bank “immune” from the influence of class struggles. The implication is that, in the era of financialisation, the central bank is not “contested terrain” but the primary defender of financial interests. This is clear in the context of financial crises, considered below.

4. Central banks and financial crises

4.1 The false belief that low inflation guarantees financial stability

The policy of inflation targeting has been eventually rendered redundant by the emergence of major financial instability in the course of financialisation. It has taken some time for this development to become clear, including several episodes of financial instability in the 1990s and the gigantic crisis of 2007-9.

The period of rapid inflation in the 1970s and 1980s was followed by nearly two decades of stability in terms of prices, output volatility and interest rates. The mainstream attributed these outcomes to monetary policy that focused on inflation targeting (Bernanke 2004). It did not take long for the false view to emerge that price stability also guaranteed general financial stability. On this basis, the central bank only had to concern itself with keeping inflation low, and the financial sector could look after itself.

Schwartz (1988, pp. 33-62 1998, pp. 34-41) has been the main advocate of the view that price stability guarantees financial stability, also shared by Bernanke and Gertler (1999a, pp. 18-51). Relying on earlier work with Friedman (Friedman and Schwartz 1963), Schwartz argued that the major threat to financial stability, especially for the banking sector, comes from unexpected changes in the rate of inflation. Therefore, by promoting price stability, the central bank “will do more for financial stability than reforming deposit insurance or reregulating” (Schwartz, 1998, p. 38). If the central bank focused on low inflation, it would apparently reduce the chances of lending booms (induced by high inflation) and recessions (induced by unexpected deflation or disinflation). The “Schwartz Hypothesis” has been tested by mainstream economists, who found a positive “association”, not causation, between price instability and financial instability (meaning bank panics).¹⁵

These views are transparently fallacious, but they rest on ideological and political considerations. The inflationary crises of the 1970s and 1980s represented failure to defend the value of credit money. That failure had social and political implications, at the very least because rapid inflation meant losses for creditors and because wage bargaining was disrupted as workers attempted to obtain compensating increases in money wages. The adoption of inflation targeting and central bank independence was a sign of the ability of the capitalist class to learn from this experience.

Thus, the convenient legal fiction of independent central banking was created, separating the electoral process from monetary policy. The latter was apparently to be determined by disinterested and class-neutral experts on “objective technical grounds”. Financial interests were assured that inflation – which is deeply damaging to them – would not be tolerated. Financial bubbles, on the other hand, were seen as irrelevant to central banking, and even declared unlikely if inflation was kept low. In effect, financial interests were told that the central bank was not going to intervene in their speculations, while protecting them from high inflation.

¹⁵ See Bordo, Dueker and Wheelock (2000) and Bordo and Wheelock (1998, pp. 41-62).

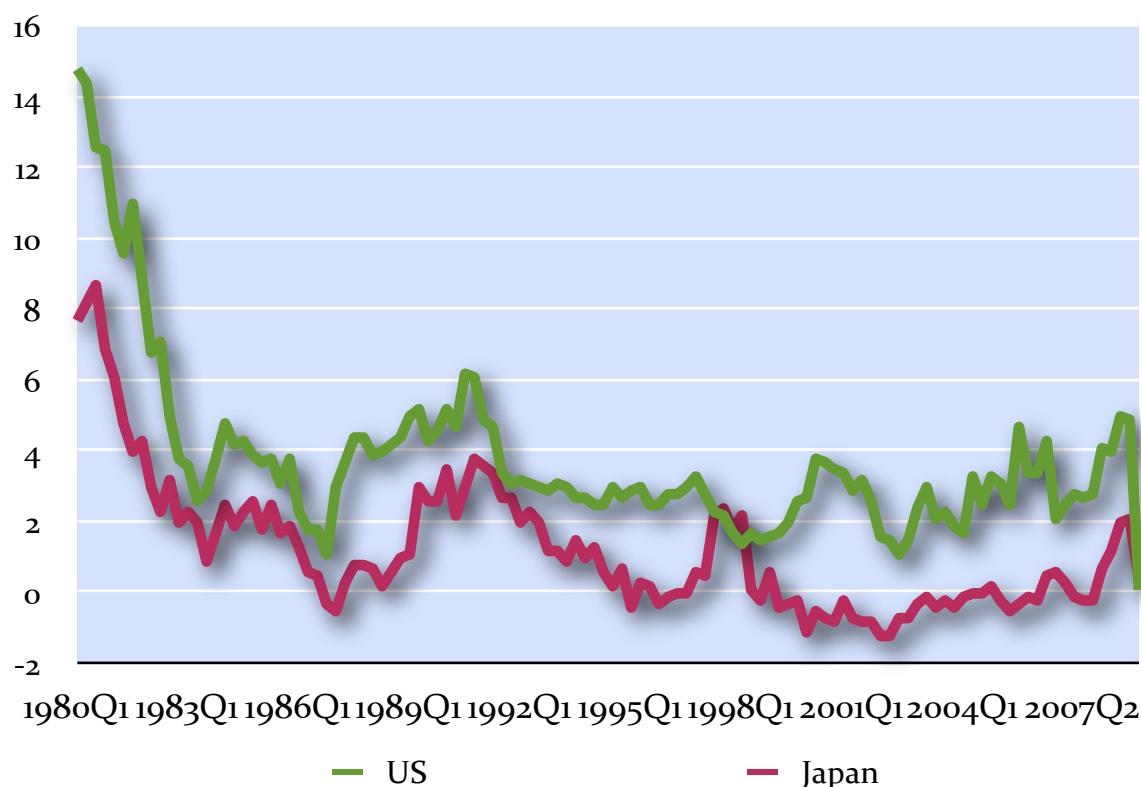
4.2 The significance of bubbles and financial crises

The emergence and burst of financial bubbles in the 1990s has undermined inflation targeting, while showing the limits of contemporary central banking. Bubbles are unsustainable, continuous increases in financial asset prices. They result from a climate of optimism, which is fostered by rises in financial prices and leads to further price rises, thus creating the phenomenon of asset price inflation. In an asset price bubble, consumers and enterprises tend to over-borrow. Rises in asset prices may also lead to a misallocation of resources through time. There might be excessive capital accumulation in the short term, for example, followed by an extended period of overcapacity. In this context, it becomes very difficult for the central bank to set monetary conditions in a way that deals with changing expectations regarding to the future pace of capital accumulation. As a result, there is greater risk of policy error.

Moreover, according to Shaikh's (1997) Marxist critique of inflation targeting, there is no homogeneity to inflationary phenomena in the context of the capitalist market process. Contrary to mainstream beliefs, inflation does not result simply, or mostly, from government policy but also from the activities of the private sector, which are sometimes revealed as changes in asset prices. These activities could undermine the ability of monetary authorities to meet inflation objectives. Consequently, it is mistaken to think that asset prices can be ignored, allowing monetary policy to focus exclusively on inflation.

It is important to note that in all countries that suffered financial bubbles during the last fifteen years, inflation was either low in absolute terms, or low relative to its earlier history (King, 1999). In each case, the emergence of an asset price bubble was closely correlated with apparent success in lowering inflation, an achievement much prized by the advocates

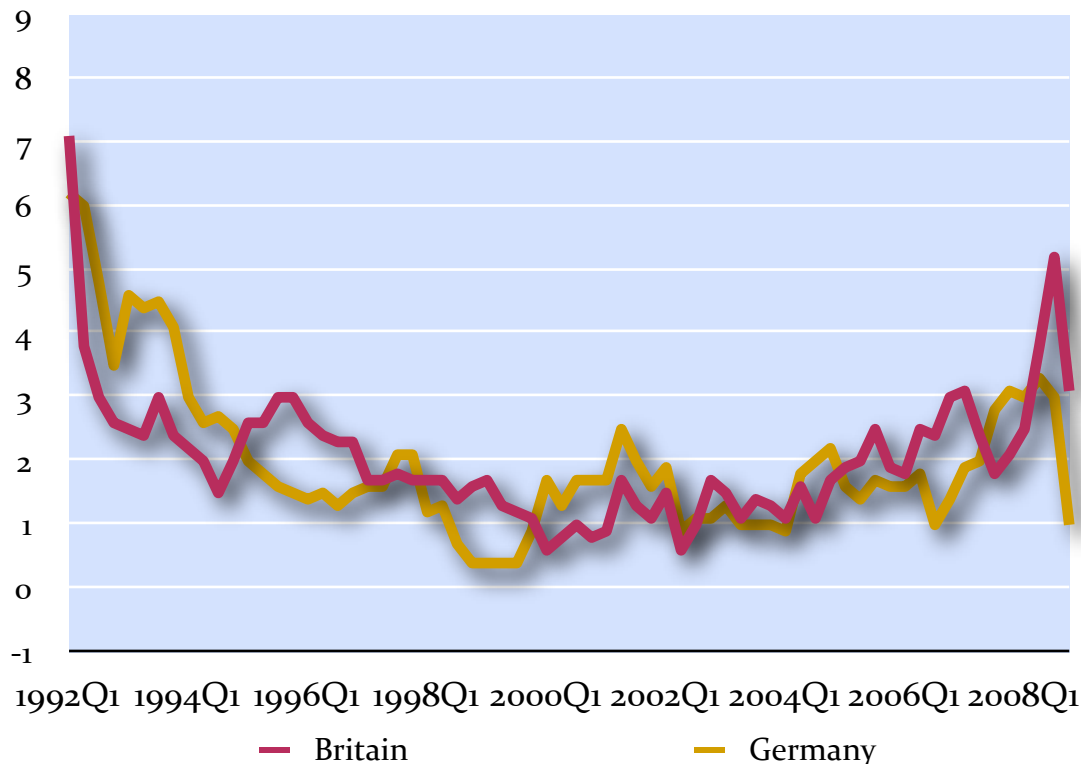
Figure 1 - US and Japan Inflation Rates, 1980Q1 - 2008Q4



Source: Bloomberg

of the so-called 'Great Moderation'. This is not to exclude the fact that sometimes low inflation was only a temporary phenomenon associated with a beneficial external shock, for instance, in the UK in the late 1980s (King, 1999, 10-18). Still, bubbles tend to emerge in conditions in which inflation remains under control.

Figure 2- Britain and Germany Inflation Rates, 1980Q1 - 2008Q4



Source: Bloomberg

It is clear from Figure 1, for instance, that Japan's inflation rate in the 1980s remained at very low levels. Even when it rose toward the end of the decade, it remained lower than that of Japan's competitors. Put another way, for much of the late 1980s, Japan would have easily met most of the inflation targets currently in use. Very low interest rates in Japan in the second half of the 1980s went together with low and stable inflation as well as rapid rises in equity and land prices.

Moreover, when asset prices started to fall, Japanese monetary authorities failed to recognise the dangers this posed for the economy. Expectations of future growth collapsed, and industrial enterprises were left with excessive debt levels that prompted a slow move toward deflation. Yet, the relative stability of inflation at the time gave policymakers an unjustified level of confidence in the underlying health of Japanese capitalism. The Japanese experience shows that catastrophic asset price bubbles can be consistent with pursuing low inflation. The US experience in the late 1990s and more recently is a similarly good example of this phenomenon. On this basis, it is probable that financial bubbles tend to develop when inflationary pressures are low and, as a result, central banks feel comfortable with levels of interest rates that eventually prove too low.

Furthermore, bubbles tend to develop when periods of low inflation are accompanied by strong expansion of the domestic money supply (see Figures 3, 4, and 5). A temporary

absence of price pressures allows central banks to tolerate excess money growth for an extended period of time. A common rationalisation is that monetary expansion is not problematic, if it reflects financial innovation. Thus, strong growth of money could in practice lead to rapidly rising asset prices which, in turn, enable borrowers to offer increasing collateral on loans, apparently lowering risk for lenders.

Figure 3 - US M3 Money Supply Year on Year Change (percent), 1980Q1 - 2006Q1

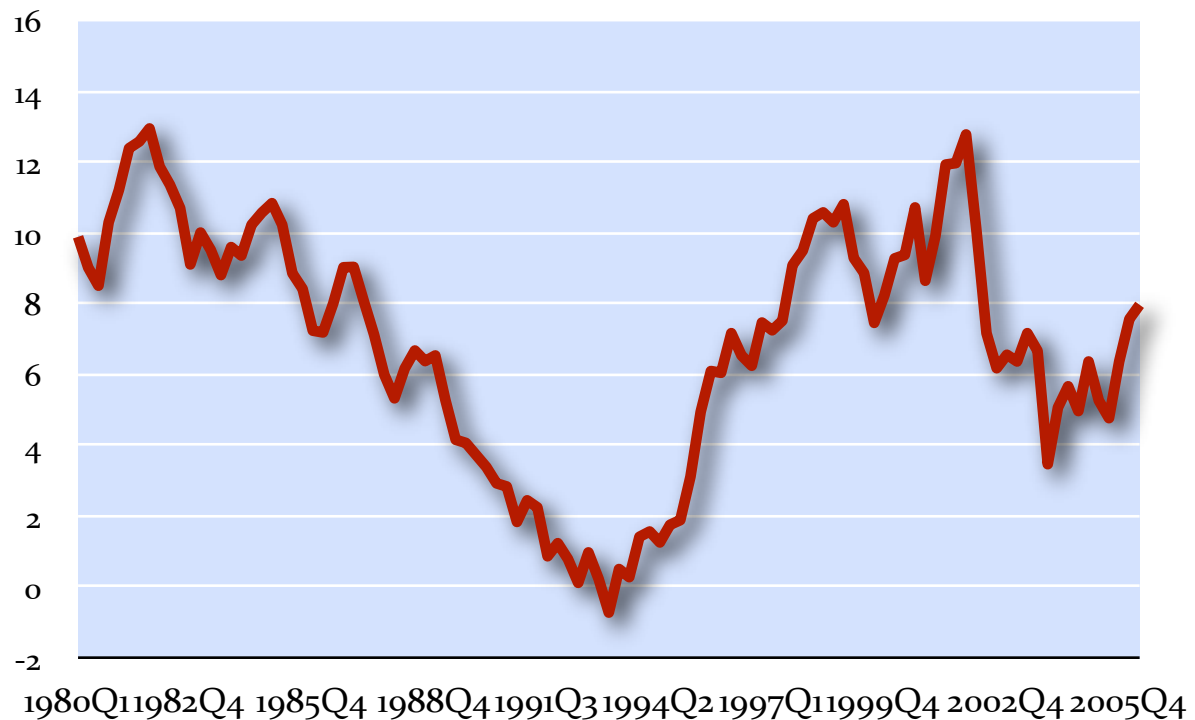


Figure 5 - British M4 Money Supply Year on Year Change (percent), 1983Q3 - 2008Q4

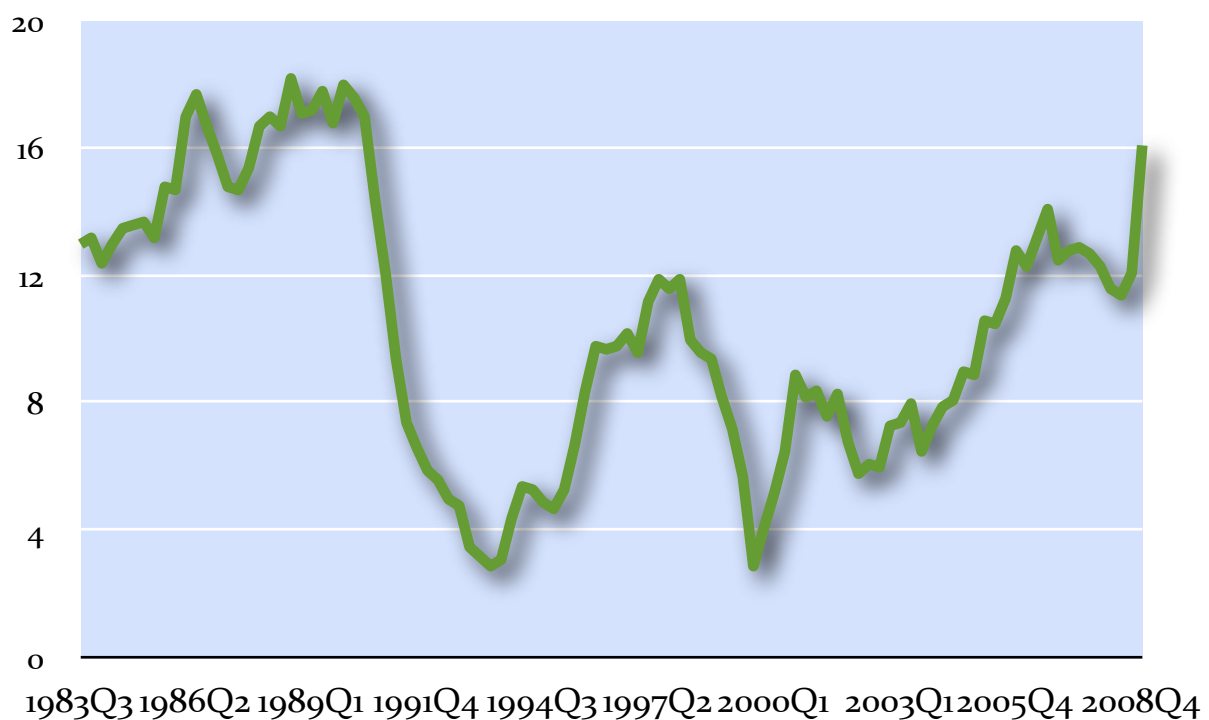
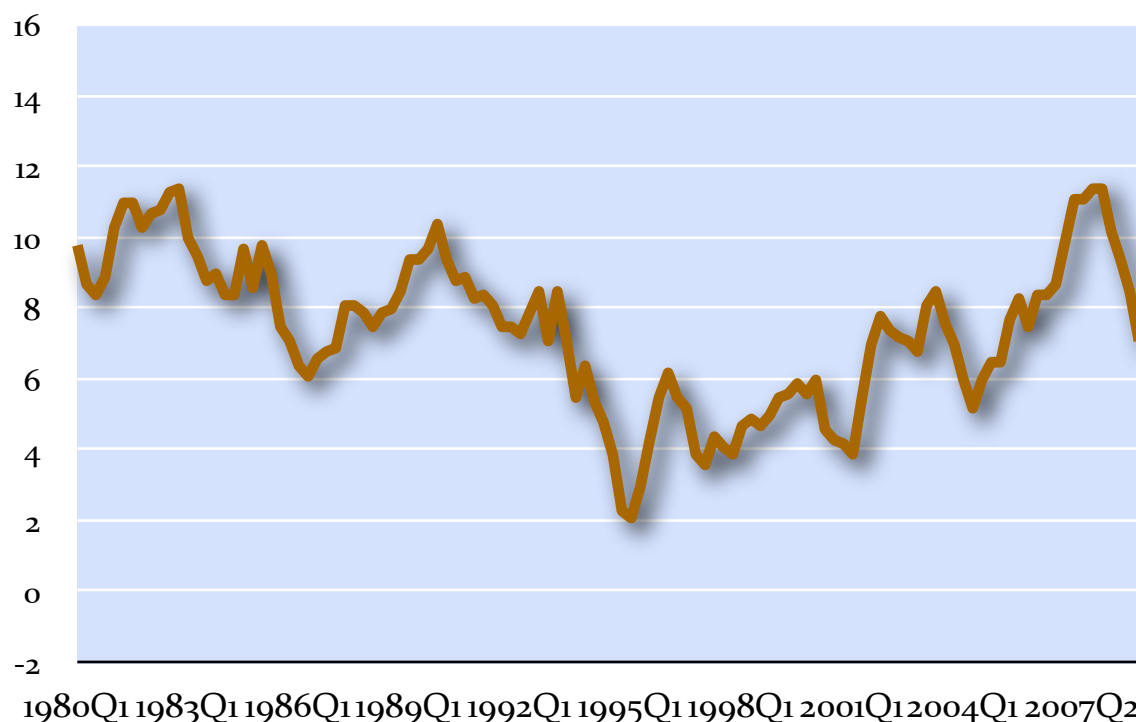


Figure 4 - German Money Supply (M₃) Year on Year Change (percent), 1980Q1 - 2008Q4



Source: Bloomberg

Finally, it is common for traditional risk assessment and valuation models used by financial institutions to break down in the course of a bubble. This phenomenon has been particularly pronounced during the US bubble of 2001-7. Technological progress and financial innovations made it possible for banks to manage their liabilities more efficiently and therefore more profitably. Instruments such as derivatives, transactions of securities, money trust, insurance, as well as a variety of other services related to open markets encouraged banks to turn toward financial market mediation. Also other activities, such as lending for mortgages, consumer loans, credit cards and so on, which turn banks toward the personal revenue of workers, became very prominent (Lapavitsas, 2009). A climate of optimism fostered a huge asset bubble, contributed to lack of proper risk assessment, and eventually led to burst. Low inflation offered no protection against the ensuing disaster.

To mitigate the consequences of bubbles bursting, central banks have tended to shift their focus pragmatically, effecting emergency changes in monetary policy. This practical response has been prepared by analytical work, such as McGee (2000) and Bean (2003, pp. 787-807), arguing that price stability offers no guarantee of financial stability. Along similar lines, Borio and Lowe 2002 have claimed that, if financial imbalances in the economy are pronounced, there is a strong possibility of financial instability triggered by price stability. Therefore they proposed the so-called 'flexible approach to inflation targeting'. This has found some support from Mervyn King, the Governor of the Bank of England, arguing that monetary policy may need to be tightened in response to rising asset prices, even if inflation is not rising significantly.

The problem is that in a capitalist economy it is very hard to distinguish at an early stage between a bubble and a period of lasting improvements in productivity performance.

Moreover, technological revolutions are often used to justify extended gains in asset prices. It is historically documented that technological revolutions often give rise to bubbles.¹⁶ This means that an initial expansion in economic activity based on productivity growth can give way to unsustainable bubbles as money supply begins to increase and asset prices rise to exceptionally high levels.

A case in point is the response of the Federal Reserve under Alan Greenspan to the so-called New Economy stock market bubble and the subsequent housing bubble in the USA. Greenspan chose to restrain neither the former nor the latter. He declared himself right not prick the equity bubble of the 1990s, allowing it to burst by itself and then 'mopping up' the mess through lower interest rates. Greenspan justified his action on the grounds that one can never be sure that what looks like a bubble really is a bubble. Apparently, he could not use interest rates to 'prick' the bubble, because interest rates affect the economy more like a sledgehammer than a scalpel. A modest rise in interest rates would be unlikely to halt rising prices, but an increase sufficient to pop the bubble would slow the whole economy and could even cause a recession. On this basis Greenspan concluded that it was safer to wait for a bubble to burst by itself and then to ease monetary policy to soften the downturn.

In practice, Greenspan allowed financial interests to make enormous profits during the bubble in the hope that the costs of the burst would not be unmanageable. It was taken for granted, of course, that these costs would be passed on to society as a whole. Thus, inflation targeting has gradually come to acquire the aspect of protecting private profits in a bubble, while socialising losses during the burst. This approach led to disaster in 2007-9.

4.4. Socialising losses to protect private profits

The crisis of 2007-9 has thrown inflation targeting in turmoil. As was previously explained, the policy can be characterised as the epitome of sophisticated monetarism, which emerged primarily because of the experience of the stagflation of the 1970s (Mayer, 2003). The policy limits the central bank to pursuing a low inflation target subject to broad rules, while downplaying the traditional function of lender of last resort.

Imposing the rule of targeting inflation rule can be quite restraining on the central bank.¹⁷ Since the capitalist economy develops dynamically, any rule which limits discretion by the central bank is necessarily static. The recent crisis has shown that the dynamic evolution of finance in the era of financialisation has undermined what was considered the greatest achievement of inflation targeting regimes, namely central bank credibility. Thus, mainstream economists are at present advocating renewed emphasis on the function of lender of last resort (De Grauwe, 2007, pp. 159-161). Others have proposed complementing that with market making of last resort (Buiter and Sibert, 2007).

The crisis of 2007-9 has manifested itself primarily as turmoil in financial markets. Uncertainty and fear, which easily extended to panic, meant that little or no trade occurred in certain classes of financial instruments. Subprime-backed Collateralised Debt Obligations, for instance, were often impossible to trade as there was no market maker capable of valuing the necessary funds credibly to establish buying and selling prices. Such market failures occurred in different ways across financial assets, including exchange-traded

¹⁶ See C. Kindleberger, 1989, 'Manias, Panics and Crashes'.

¹⁷ Even when it is perceived as 'constrained discretion', as in the USA, which allows for stabilisation of output and employment subject to a declared target range for inflation. See Bernanke, 2003.

and over-the-counter instruments. But a common solution has been suggested: the central bank should be the market maker of last resort. The function of market maker of last resort, could involve, first, outright purchases and sales of a wide range of private-sector securities and, second, acceptance of a wide range of private-sector securities as collateral (Buiter and Siebert, 2007, p. 171-172).

But extending the function of the lender of last resort and complementing it with the function of the market-maker of last resort would be far from easy. First, severe moral hazard problems could arise as central banks substituted public credit for bankrupt private credit. On this basis, Vives (2008, p.99) has even argued that the outbreak of crises might be desirable to maintain investment discipline. It is even postulated that some barely solvent institutions should not be rescued.¹⁸ Second, it is possible that as central banks acquire problematic private securities, their own solvency might become problematic (Buiter 2008). Thus, it is proposed that the state (as national fiscal authority) should provide ultimate support for the central bank acting as lender and market maker of last resort. One way of doing this would be for the state explicitly to underwrite the balance sheet of the central bank.

From the Marxist perspective adopted in this paper, the proposals are evidence of the central bank being used to socialise losses in order to protect private profits. Central bank independence and inflation targeting have allowed repeated bubbles to emerge, partly because of low inflation rates. The ensuing disaster has led to renewed emphasis on lender of last resort supplemented with the novel function of market maker of last resort. Financialisation has turned central banks into the main agent protecting financial interests at the expense of society as a whole.

4. Conclusion

The current period of capitalist development is characterised by an apparent paradox: the political power of central banks continues to rise, while their economic power is in serious doubt. This paradox is related to the role currently played by financial interests in promoting capitalist accumulation as a whole. Thus, in the era of financialisation the central bank has emerged as the primary protector of financial interests. The basis of the power of the central bank is provided by its monopoly over legal tender, and this has been greatly enhanced in the course of financialisation. But the inherent instability of the capitalist economy, to which monetary and financial factors contribute strongly, sets limits on what central banks can do. The relative autonomy of the credit system is an important factor in explaining financial instability in mature capitalism. In the era of financialisation, during which financial fragility has increased, the triggering of financial crises also has political aspects. It is similarly subject to considerable inter-class struggle between financially fragile (and thus less competitive) capitals and financially strong (and more competitive) capitals.

Inflation targeting and central bank independence have aimed at promoting capitalist accumulation at the expense of working people by “immunising” central bank from the effects of class struggle. Inflation targeting and central bank independence have facilitated extraction of private profits at the cost of increased financial instability with enormous ensuing losses for society. Capitalist states now recognise that central banking must go beyond inflation targeting to protect the capitalist system from itself, without however

¹⁸ From a different perspective Dickens (1990, pp. 1-23 1999, pp. 379-398) argued that financial instability is a problem created by the dynamics of the capitalist market reflecting the contradictions of capitalist accumulation. Financial crises are primarily due to political decisions and are political in nature.

abandoning the neo-liberal agenda. This has meant renewed emphasis on the function of lender of last resort supplemented with the newly-fangled function of market maker of last resort. In practice this amounts to socialising financial losses in an effort to preserve private financial profits. Nonetheless, the crisis of 2007-9 has shown that there are limits to what central banks can do to stabilise finance.

As the burden of financial instability has become greater for the vast majority of society, the need for central banks to be subject to democratic control has become clearer. Through social control, central banks should be made to reflect the broader interests of workers and others, rather than primarily those of banks and finance. Central banking is often called an art, but it should certainly not be an art for the benefit of the few.

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