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THE NATURAL PRICE OF MONEY MAKES THE INDEPENDENCE OF CENTRAL BANKS OBSOLETE

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Abstract: *Relying on the theoretical meaning and the normative value of the natural rate of interest, as inherited from the founders of the economic science, this article aims to demonstrate that the independence of central banks can only be a technical one – one of "dentists", as Keynes would say. To prove our thesis, we set out to build our analysis onto three directions. First, we identify arguments to show that excessive independence, by means of the 'new classical economics', is not sustainable. Then, we show how the natural rate of interest renders the central bank more disciplined and shapes its independence only within technical boundaries. And thirdly, we show how the attempts to preserve its extended independence by keeping some features of the natural rate remain tentative.*

Keywords: *natural rate of interest, central bank independence, monetary policy*

JEL classification: *B12, B13, E4, E5*

1. Introduction

At least in the last 40 years, no other kind of independence has aroused as much interest as that regarding central banks. The explanation lies not so much in the fact that a central bank is a very important player in an economy and, consequently, it must be given room for manoeuvre, but in the fact that, through its job description, it is empowered to manage money.

Posing serious problems to the theory and practice of economics, the idea of central bank independence (CBI) has had its sinuous dynamics. There is the pre-classical phase, when minds and pens drawing on the School of Salamanca outline the profile and boundaries within which the activity of a central bank must be unfolded, without explicitly raising the question of its independence. The classics addressed the issue against the background of the analysis of the role and functions of money, as well as the relationship between the central bank and the government within this context. Although the phrase was not part of their conceptual toolbox, "temporal inconsistency" came through, claiming barriers to the governments' desire to indulge in money without too many restrictions. An independent central bank was seen as the solution to the problem. Nevertheless, a technical, professional independence emerges from their writings.

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The classical dowry on the subject served as a basis for Wicksell's synthesis. It was mainly an extension of the Ricardian analysis towards the perimeter of the interrelations between the natural rate of interest on the one hand and, on the other, the balance between the labor market, goods, and economic growth. However, it so happened that the result of the Ricardian-Wicksellian analysis was not entirely digestible by the central bank. Therefore, a 'new classical revolution', inspiring and supporting a new banking science, tries to ground the idea of independence on other bases.

Within this conceptual framework, continuing and extending the argument of Pohoata et al (2024), we aim to show how the natural rate of interest, the strong contender of the Ricardo-Wicksell episteme, is the toughest argument that turns the central bank independence obsolete, as it is seen by the 'new classical economics". As subsequent objectives, first we set out to show that the CBI, by means of the 'new classical economics' has subjective foundations, it is anti-systemic and anti-institutionalist; moreover, it is based on an unsustainable assumption - inflation is intrinsically a monetary phenomenon. Second, we want to show that the independence conceived on the matrix of the natural rate of interest can only be a technical one, one "of dentists".

2. Why does the central bank independence, by way of the 'new classical economics', fail to be convincing?

A common practice to ensure the strength of a fortress is to build a protective wall and only afterwards, forge the means of defense. The artisans of the idea of the CBI, as it is shaped today, also worked on such a logical scheme. More precisely, they found support in reputed names belonging to the 'new classical economics'; they induced the idea of the existence of a banking science overlapping with but also autonomous from economics; they encouraged the establishment of an institution which enjoyed the status of rule, and which protected them from the advice of others. The method, in a nutshell, reads as follows: (1) As much econometrics as possible, to define the institution's high status; (2) A persistently cultivated eclecticism conceived to guide anyone troubled by the question of independence through all areas of economic science: inflation, prices, employment, money, credit, value, interest, exchange rate, budget, financing, etc.; (3) Taking on, *pro domo*, some attributions, extended to the limit that allows the legitimate question of whether the government has anything left to do; (4). The creation of the bankers' own study circles, to which the academia is half-heartedly welcomed (see Forder's (2005).

The center of gravity of the pro-independence line of argument is built around *time inconsistency*. Put forward by Kydland and Prescott (1977), the alleged discovery aims to explain the inherent penchant towards inflation – inflation bias – of the political factor and, hence, the need to delegate money management to an independent neutral player, that is, the central bank. In relation to a government with propensities to cheat when it comes to money, there was a need to work on the central bank's image, legitimacy, and reputation. The ledger can be summarized to the following sentences: (1) The central bank is an organization which issues rules, and the meaning of this process is unique; (2) A contract of the Principal – Agent type grants institutional legitimacy to the CBI; (3) A conservative central banker is almost a sufficient guarantee in the fight against inflation; (4) The quality of lender of last resort is self-explanatory; (5) From a budgetary stance, the central bank is autonomous; (6) Only an independent central bank can refuse direct budget financing.

First, the way in which the supporters of CBI look at the relationship between organizations and institutions – in the sense of rules, of good practices – prepares the ground for the manifestation of an independence without clearly outlined boundaries. The New Institutional Economics argues that it is the good rules, and observing those rules, which keep the economic dynamics going and ultimately progressing. A rule which has the status of good practice is always the expression of a consequence, a synthesis of what is repeatable and has a stable character in the dynamics of a phenomenon. Nevertheless, the idea of CBI seems to avoid this aspect. The central bank appears not as a synthesis of an institutional arrangement, infused with rules, but as a generator of such rules. From this perspective, it is a player just as important and imposing as the government. The speech of Mario Draghi (2012), the former president of the ECB, that "within our mandate, the ECB is ready to do whatever it takes …" supports Bibow's (2004) argument that the CBI represents 'discretion rather than rule' that promises the chimerical free lunch. Fischer (1990) rightly reckons that replacing a set of rules with an alleged *Principal-Agent* contract, replete with central bank rights, does not ensure the desired neutrality of monetary policy by an independent central bank (Aglietta, 1992). We say alleged because, *de facto,* the Principal-Agent contract does not exist in an authentic form. We only have references to it by way of the works of the artisans of the idea, Walsh (1995) and Persson and Tabellini (1993). From their works we learn that it is an incomplete type of contract that a central bank completes with whatever it thinks it can take on regarding its multiple forms of independence. In other words, we argue that such a contract is not negotiated by anyone, it has nothing to do with the spirit of the market, and the responsibility to comply with the clauses ranges from diffuse to non-existent.

Within the same paradigm, running away from clear rules, necessary to acquire responsible behaviour, also fits the construction of the *conservative central banker*. Rogoff (1985), Barro and Gordon (1983) undertake the task to project, the prototype of the omniscient governor, allergic to inflation, sentimentally broken, highly skilled at handling money to reach its sole purpose – public wellbeing. If there is a place where the theory claiming the CBI borders on hilarity, then the picture of the conservative central banker who replaces all the rules is the most compelling example.

The idea of independence also claims to gain glory through the assertion that the central bank enjoys *budgetary autonomy*. That is: it thinks and acts on its own, covering expenses from its own resources. By setting its own salaries, and supposedly conditioning the governor's salary to achieving the goals regarding inflation, pouring a large share of the profit into the accounts of the Ministry of Finance, the central bank poses as incorruptible. It would be credible if we learned that the salaries of famous governors dwindle whenever inflation targets are missed (Angeriz and Arestis, 2006; Rochon, 2006; Fullwiler and Allen, 2007).

And, finally, as noticed, the temporal inconsistency is the innovative argument of the alleged founders in claiming independence. Detaching the central bank from finance and fiscality remains an illusion, even it does not wish for such a thing. Then, a completely depoliticized central bank remains an illusion. Overall, the temporal inconsistency logically argues that a professional authority is better suited to deal with the distribution of public money than a public power that is always under the pressure of voting. If, under the influence of this argument, the central banks are left with a purely technical, professional independence, it is acceptable. The central banks emerged to finance governments. They indirectly served the public interest. Now, wrapped in independence, they are barred from government. Neither then, nor now, does the government produce the money it needs. That is why, no matter how much literature or econometrics is spent on convincing that the central banks refrain or are forbidden to supply governments with all that is necessary seems an easily perceptible fake. We add here the fact that in a system the atom called monetary policy is in conjunction with the one called fiscal policy. The two pieces cannot be "monads", that is, some independent entities, which do not communicate but fit into a whole. In our case, the two "atoms" communicate and are umbilically linked by the common string called money.

It is hard to say whether there is any hierarchical order regarding the importance of the six statements dealt with above. We believe that none of the six ingredients making up the impenetrable frosting of the CBI plays this role by itself. The privilege is relegated to the background and the background is ensured by admitting the hypothesis that *inflation is intrinsically a monetary phenomenon*. If inflation is purely monetary, unrelated to the real economy, it is the central bank's duty and exclusive privilege to manage the phenomenon. Only on grounds of such a hypothesis can one be allowed the idea of an autonomy of the nominal economy from the real one, and on such ground alone can the statue of an independent central bank be built. Only on such grounds, the empirical studies found that while CBI reduces the level of inflation, it has no measurable impact on real economic performance (Alesina and Summers, 1993; Eijffinger et al., 1996). Its amount is in the hands of the central governor, not relegated to the world of goods.

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3. What the real founders say. The natural rate refutes the lax independence of central banks

Pohoață et al. (2020; 2021) tangentially dealt with this issue, emphasizing that decoupling from the natural rate of interest serves as an argument for the phantasmal independence of central banks. However, in this section we want to say something about the views of the founders of economic science in relation to the CBI.

3.1. Setting the ground

For the pre-classics and classics, the world of money holds no secret. No one commands it, it does not come out of nowhere, nor does it get sent by fax. The exchange summons upon it and imposes it. And then, it turns into rule, institution – clearly meant to measure values and facilitate exchanges. Mercantile monetary quantitativism echoed but it influenced the classics within reasonable limits. The relationship between the volume of goods and the money supply was discussed, by the latter, in terms of certain laws. Although the objective theory of value served as a background to everyone, except for Marx, the classics did not make a mantra out of the standard of value, nor did they remove it from the equation. It was Menger who took it out, and so did later all the Austrians and neo-classic contemporaries. And Keynes as well. But clearing the standard of value and granting exclusivity to the function of money as a medium of exchange set the ground for monetary laxism (Blaug, 1990). A hypostasis where money is detached from the world of goods, it moves according to its own laws. And, if possible, according to the laws that the central bank itself dictates. These are the sources of the idea of independence according to the 'new classical economics'. It is on this ground that the logic of the natural rate of interest is created, similarly to the operation logic of the central bank. The logic passes from Smith, Ricardo, Böhm-Bawerk, Wicksell and Keynes. They are, in our opinion, the true founders.

Clarifying for all those interested in a natural functioning mechanism of a central bank is what Ricardo says, onto two directions. First, "the interest for money it is not regulated by the rate at which the Bank will lend but by the rate of profits and which is totally independent of the quantity, or of the value of money" (Ricardo, 2001). The "interest for money" will turn, in Wicksell's terms but in keeping with the Ricardian logic, into the natural rate of interest; the famous "illusion" of those who try to escape it (Evans, 2020). This differs from the "legal percentage" that Smith talks about, and that Ricardo agrees with – "legal percentage" with two restrictions: a maximum that protects the borrower; a minimum that ensures the bank's proper functioning. Second, wondering who should handle money management – the government or the central bank – Ricardo provides the following, memorable, answer: As a "representative of the people", the state would have this right. Except that, he argues, "the danger, however, is, that this power would be more likely to be abused, if in the hands of Government, than if in the hands of a banking company" (Ricardo, 2001). And Ricardo adds to provide us with the origin of a possible abuse from the state: the state "would be too apt to consider present convenience, rather than future security". Who is willing to see that in this last sentence is found, condensed but clearly formulated, the core of the theory about the future famous "temporal inconsistency". Ricardo did not use the exact same words, but it can be seen from the context that he thought about the phenomenon in question. Ricardo's trust in the bank is not complete. "Limitation of quantity" appears to him as a necessary objective and he sees a danger in the fact that money management depends "solely on the will of the issuers". Between the government and the bank, the bank is preferable; it is more qualified and more inclined towards "future security"; yet not without limits!

We learn from Wicksell (1962) that the "interest for money" is natural and gets this name by reference to the rate of profit. Concerned with his well-known synthesis, he takes from Böhm-Bawerk the idea of an interdependent relationship between capital and real production. The reference to the origin of the decision regarding the purpose and amount of the interest is preserved: the aim, purpose and mission of the bank resides in "the valuation of the borrower for productive purposes" (Böhm-Bawerk, 1930). With such sources, Wicksell provides an inspiring analysis of the relationship between the natural rate of interest and the money rate of interest, one in which the natural rate is both cause and benchmark for the money rate. If so, then the natural rate must be known in advance, as a lighthouse. And how do we find it? Keynes (2013) who, drawing direct inspiration from Wicksell, writes that "the banking system is in a position, under a regime of representative money, to determine—broadly speaking—the rate of investment by the business world". At the same time, in the *Treatise*, he explains once more, the three Wicksellian meanings of the natural rate of interest: a) the average rate of estimated profit; b) the rate that maintains the equality between savings and investments; c) the rate at which full employment is ensured. The first meaning has the role of a forerunner. If the central bank takes its mission seriously and conceives its monetary policy rate according to the expected average rate of profit, the rest flows naturally; savings are absorbed by investment and employment is likely to be high.

Prices, their "targeting", are not bypassed. Following in Wicksell's footsteps, Keynes describes the cumulative process by which prices are influenced by the interest rate on loans, not directly but through its effect on the investment rate. Analysing all the situations in which the rate of interest on loans relates to the expected rate of profit (natural rate), Keynes also notices the gap after which the natural rate drags the market rate. This is because, he believes, the banking world does not quickly detect changes in the natural rate. How do we react to this? Do we target prices? No way. Authority belongs to the natural rate of interest. So, listening to Ricardo, Wicksell, and Keynes, we identify the average rate of profit and keep the interest rate on loans below it. This is what the central bank needs to do.

In conclusion, this is the framework in which money moves and a central bank can fulfil its mission according to the founders of economic science. A few essential things are worth highlighting from their writings: (1) We learn that the key player in the interest rate determination mechanism is the entrepreneur and not the central bank.; (2) The natural rate precedes, it comes first; the money rate, comes crawling after it. Consequently, the philosophy of interest is subject to the philosophy of the real economy, not the other way around (3); The disjunction from the real economy and the claim for independence are against this logic. 'Targets' of any kind would take it out of this framework. And once out, then Yes, it becomes possible to play with money, with money from nothing and for nothing, which is likely to end in a purely monetary or purely banking inflation. Except that, held back by a natural rate that would dictate its conduct. The refusal of the natural rate becomes imperative.

3.2. Saving independence by mistreating the natural rate

With or without the natural rate of interest, the central bank could issue currency, handle the exchange rate, and even act as lender of last resort. However, the natural rate confiscates its 'targets' and that amounts to a relativization that is hard to accept. To mitigate this risk, theoretical attempts come to rescue. Woodford (2003), Taylor (1993) and Laubach and Williams (2003) are some highly recognized examples that make such an attempt. What do these authors do? Basically, they try to update Wicksell's natural rate concept. The result is a surrogate, on its own, that no longer has anything to do with the founding logic of the concept.

Firstly, Woodford (2003) gives the natural rate of interest a personal touch: a balance rate in an ideal economy, with perfectly flexible prices that allow potential GDP to equal aggregate demand. What Woodford envisages is not far from Wicksell's philosophy, but it is not within it either. The bottom line, the fact that the natural rate is the perceptible mirror image of the expected rate of profit, is missing. And with this contribution he finds himself in a DSGE model, the mantra of the so-called modern central banking. Basically, the model is a confusing econometric exercise, convenient for the central bank, where the poor Philips curve allows the econometric mixing between natural rates of unemployment, output and interest, possibly a potential GDP, freely chosen between *ex ante* and *ex post*, and comes out in the end as a bride wearing the veil of the supply equation.

Secondly and similarly, Laubach and Williams (2003) and Mesonnier (2005) are also animated by the idea of estimating the dynamics of the nominal interest rate over large areas and over long periods. But they do not consider Wicksell's "illusion". The latter builds its own working definition of the natural rate of interest as a real short-term rate compatible with a zero-output gap and stable inflation over the

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medium-term horizon. With such a vague definition, foreign to Wicksell, he reaches a matching conclusion: "the estimated natural rate is surrounded by total uncertainty" (Mesonnier, 2005).

John Taylor (1993), with his famous formula, is auspicious for central banks. Attempting a synthesis and taking something from Wicksell, Fisher, and Keynes, he builds upon his well-known formula. It is designed to serve the central bank and it assumes a "divine coincidence" between the desired rate of inflation and potential output. The equilibrium real rate of interest is connected to the relationship between the level of full employment and a targeted rate of inflation. The break between the neutral rate and the rate of profit is visible. The fog thickens with the suggestion to set the nominal interest rate according to the difference between what is targeted and what is observed in the evolution of inflation.

All in all, both DSGE models and Taylor's rule indicate the same thing: the intention to free the central bank from the straps of a disciplinarian natural rate and place it in the comfortable position of an absolute and independent conductor. If these calculations outline any natural rate, it is defined distortedly, broken from the Ricardian-Wicksellian logic and from the real world of entrepreneurs.

4. Conclusions

The perception of money is very important in the construction of the idea of the CBI. Neglecting the function of money as a standard of value fuels monetary laxism and calls for a bank that is not only independent but one that dominates the entire financial-monetary area. The economic world of the true founders of the idea of independence links the world of money to that of goods. In this world, the natural rate of interest has the status of a natural price. If it accepts it, the central bank understands that it cannot handle money and inflation alone. The government is equally responsible for how demand meets supply and how market prices are formed.

On a trajectory that has already become history, it is not easy to accept that the institutional body of the CBI is outlined in Ricardo and Wicksell's works. But there, independence is no longer a postulated truth. On the contrary, it can be acquired from within, only technically and through the exercise of providing qualified service to the economy. And its exercise, in connivance with that of the entrepreneur, is public. No deal with the government is of any use. And nothing in its attitude is against democracy. In short, the natural rate of interest prevents one from thinking and acting wrongly or complicatedly.

The natural rate of interest appears as an element of a network. A network in which it seems logical that no piece of the ensemble is allowed to be its own master. In short, even if independent as regards the instruments available, the central bank cannot allow itself to be an oasis of Bonapartism in the institutional ocean of the free market and the cobweb of rules that shape and defines the economic body as a whole. Rational anticipations will also come upon them, helping them realize for themselves that there is no free lunch for anyone, not even for the central bank!

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