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Nearly nine years after the 2008 Global Financial Crisis (GFC), the European Union (EU) is struggling to recover. What started as a housing crisis in the United States spilled over into Europe and grew into full-blown economic struggle for countries inside and outside the European Monetary Union (EMU). Now, the European Central Bank (ECB), the institution charged with overseeing the EMU, is charged with stabilizing the entire banking system throughout the Eurozone.[1] This is only the most recent effort to address what has become the "new normal" in the EMU through the expanded mandate of the ECB.

In an age of globalization, the role of the ECB is greatly important to all players in the economy. The effects of the 2008 financial crisis demonstrate the dangers of contagion, especially for countries pushing for greater economic liberalization.[2] So, what implications do crises have for efforts to encourage economic liberalization, like encouraging central bank independence? What will these unsettling times mean for the long-term relationship between governments and independent central banks?

In this paper, we examine when political leaders will support or undermine the legitimacy of independent central banks in the aftermath of economic crises. We argue if a government is optimistic about its chances of retaining power and securing economic recovery, it will be more likely to issue positive, legitimizing statements toward its independent central bank. We evaluate this argument using the compelling and important case of the ECB following the 2008 GFC.

Our study makes a number of important contributions to both academic and policy communities. First, we highlight an important link between political and economic policy spheres using the mechanism of optimism. Previous studies have demonstrated the impact of optimism on individual activity in the economic market, but our study extends this research in a new area by using optimism to link political and economic activity.[3] Next, we seek to further unpack the concept of central bank independence by highlighting the small but meaningful ways legitimacy

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[1] Danny Hakim, "The Man Who'll Do Triage on Europe's Banks," *New York Times*, 2013.
[2] D. Das, "Globalization in the World of Finance," *An International Finance Reader*, New York (2003): Routledge, pp. 3-11.
[3] A. Cukierman, "Monetary policy and institutions before, during, and after the global financial crisis," *Journal of Financial Stability* (2013): 8.

can be chipped away from these institutions. We are answering the call from scholars to examine how financial crises can impact these institutions.[4] Finally, we add to the growing literature that seeks to further explain the implications of the Eurozone crisis and the role of the ECB in resolving that crisis. By showing the importance of political optimism, we contribute to the broader discussions of how to manage the crisis and how to resolve it.

The Significance of Central Bank Independence

Extant literature suggests that central bank independence (CBI) is a viable strategy for states to use to stabilize domestic economies, which could help prevent and respond to financial crises. Cukierman, Webb, and Neyapti test the relationship between legal CBI and inflation in 72 countries over four decades. The authors find higher levels of CBI have a negative relationship to levels of inflation and a positive relationship to price stability.[5] Thus, making the central bank an agent with a mandate for price stability allows the government to follow through with goals established in monetary policy. Therefore, if CBI were found to strengthen these long-term goals, states would be less likely to experience currency crises.

Alesina and Summers build on these findings by providing further evidence that delegating monetary policy to independent central banks promotes price stability. The authors argue the preferences of independent central banks are likely to be even more inflation averse than the preferences of society at large. Therefore, the independence of central banks from politicians with short-term goals helps to ensure long-term price stability in domestic economies.[6] Both of these studies demonstrate the positive impact of CBI on domestic economic performance as well as government credibility in the international economy.

More recent scholarship has shifted the focus toward the interrelationship between CBI and political consequences. Bernhard and Leblang demonstrate expectations of a currency crisis can precipitate the end of a government and different types of governments can influence the probability of a currency crisis.[7] Clearly, then, governments are sensitive to financial markets and may be willing to take different political strategies to ensure political survival in the face of impending financial crises.

Pascal Petit demonstrates the strong connection between politics and economic crises in the context of the EU after the 2008 GFC. He argues, "the euro crisis is in the first place a political crisis," rather than simply an economic crisis.[8] For Petit, strong political leadership is critical to resolving the crisis and allowing the ECB to function properly. Again, we see scholarship pointing to a strong connection between political choices and economic outcomes.

Our study extends previous research by emphasizing how CBI can be used specifically as a strategy to overcome financial crises. Moreover, we extend the current literature to investigate to what extent political actors attempt to legitimize or delegitimize the central bank's efforts to respond to financial crises.

The Political Choice of CBI

We conceptualize the relationship between the government and the central bank as a principal-agent framework. All governments have, by law or tradition, individuals or institutions designated as the principal policymaker for monetary and financial policy. In every case,

[4] W. Berger and F. Kismer. "Central bank independence and financial stability: A tale of perfect harmony?" *European Journal of Political Economy* 31 (2013): 117.
[5] A. Cukierman, S. Webb and B. Neyapti, "Measuring the Independence of Central Banks and Its Effect on Policy Outcomes," *The World Bank Economic Review* 6 (1992): 353-398.
[6] A. Alesina and L. Summers, "Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence," *Journal of Money, Credit, and Banking* 25 (1993): 151-159.
[7] W. Bernhard and D. Leblang, "Cabinet Collapses and Currency Crashes," *Political Research Quarterly* 6, no.3 (2008): 521.
[8] P. Petit, "Building faith in a common currency: can the Eurozone get beyond the Common Market logic?" *Cambridge Journal of Economics* 36, no.1 (2012): 273.

principals have the capability and willingness to consider delegating this power to agents, either informally or formally, through legal processes. In the EMU, the preferred agent is a central bank, and the primary choice a principal must make in the case of delegation is to what degree they will allow this agent to have independence.

Governments will delegate monetary policy to independent central banks to increase the credibility of a state's commitments to monetary policy and to increase the ease and efficiency of the signaling process itself. By tying their hands to a specific monetary policy through increasing the independence of central banks, policymakers signal to market actors they are serious about committing to their policies without the interference of short-term political goals.[9] Once the goals of central banks are clearly stated and independence is established, market actors must only look to one focal point for information regarding a state's monetary policy.[10]

However, during monetary and financial crises, this principal-agent relationship comes under stress. Financial crises often result in price instability, inflation, and general economic instability—all of which are concerns central banks are designed to mitigate. While financial crises have severe economic consequences, these conditions are also dangerous for the political climate of states, as economic instability is known to create public dissatisfaction and unrest.[11]

In times of crisis, the principal-agent relationship becomes particularly salient for governments. One key benefit of making central banks independent is the insulation from short-term political goals that allow central banks to focus on long-term economic stability of their domestic economies.[12] However, long-term goals can often be at odds with short-term demands by the public, such as reducing unemployment in the short term rather than controlling inflation in the long term. Thus, vulnerable governments may choose to delegitimize their independent central banks to open the possibility for short-term economic policies.

The central mechanism for determining whether governments will alter their relationship with central banks is optimism, which is an opinion by a political elite that she will remain in power. From an economic perspective, we know that optimism is a key stimulus to the economy. Consider the following quote from Cukierman:

> When agents in the economy are more optimistic, they tend to borrow and lend more. This leads to larger levels of credit. At higher levels of credit, both borrowers and lenders are more exposed to negative news. Consequently, when new negative information arrives, the likelihood of a financial crisis is larger when leverage is higher. In addition the recessionary impact of the crisis is stronger when leverage is larger.[13]

We believe, therefore, that optimism is equally powerful in the political sphere. Just as economic agents will regain confidence in optimistic economic climates, so too will political agents respond positively to optimist outlooks.

Therefore, if governments are optimistic that they will retain power, governments will be more likely to continue to legitimize the work of independent central banks in managing monetary policy. In these cases, governments feel they are less vulnerable to the public and are more willing to allow central banks to manage crises with a long-term outlook. However, if governments are less optimistic about their survival, we argue that governments will attempt to take back control of monetary power and seek to delegitimize independent central banks. Less optimistic governments will seek to take back control of monetary policy in an effort to show the general public it is in control of the economy. Moreover, less optimistic governments might believe they

[9] W. Bernhard, J. L. Broz and W. Clark, "The Political Economy of Monetary Institutions," *International Organization* 56 (2002): 693-723.

[10] D. Leblang and S. Satyanath, "Institutions, Expectations, and Currency Crises," *International Organization* 60 (2006): 245-262.

[11] Bernhard and Leblang, *Political Research Quarterly*, 518-530.

[12] W. Bernhard, J. L. Broz and W. Clark, "The Political Economy of Monetary Institutions," *International Organization* 56 (2002): 693-723.

[13] A. Cukierman, "Monetary policy and institutions before, during, and after the global financial crisis," *Journal of Financial Stability* (2013): 8.

are more politically vulnerable and will look for short-term solutions, which are less likely to be offered by independent central banks.

> *H1*: High levels of government optimism will result in greater support of central bank independence.
>
> *H2*: Low levels of government optimism will result in less support of central bank independence.

Research Design

The European Union's response to the 2008 GFC provides an ideal case in which to evaluate our argument. The European Central Bank is the institution in the EU that has the greatest influence over monetary policy; the ECB acts as the supranational coordinating bank for the national central banks in Europe using the euro.[14] The primary objective of the ECB is to maintain price stability, although the ECB has also been responsible for overseeing the introduction and stability of the Euro since 1999.

Recently, the mandate and role of the ECB changed dramatically. While the crisis originated in the United States of America, it had a profound impact in Europe. In particular, the GFC caused real estate bubbles to burst in vulnerable countries like Spain and Ireland. The GFC also forced inevitable collapse in countries relying on high taxes and consumer spending to uphold their solvency. Altogether, the GFC had the strongest impact in Greece, Italy, Ireland, Portugal and Spain, which collectively have come to be known as the GIIPS countries. The interconnected nature of the Eurozone meant financial crisis in five countries now impacted eighteen countries directly, through monetary and financial policy. Additionally, the interconnectedness of the Eurozone meant the responsibility to address and resolve the crisis must come from one unified source. Consequently, the ECB has been forced to step into a crisis management role that it was otherwise unprepared to assume.

[14] J. Wrase, "The Euro and the European Central Bank," *Federal Reserve Bank of Philadelphia Business Review* (1999): 3-4.

To examine our hypotheses, we focus on three key states within the EMU—Germany, France, and Greece. We focus on Germany as a country that has been at the epicenter of managing the Eurozone crisis. The ECB is modeled after, and is adjacent to, the German Bundesbank in Frankfurt. Consequently, German politics play a much larger role in policies and functions of the ECB than other states in the EMU.[15] Additionally, German Chancellor Angela Merkel stands apart as one of the most politically secure leaders throughout the EMU. Even though Merkel faced re-election within the time frame of our analysis, few scholars or policymakers ever considered her vulnerable, which cannot be said of many politicians in the rest of Europe.[16]

We also focus our study on France, as it is the second most influential state in the EMU.[17] Moreover, considering our theoretical approach, the French case offers us the example of a politically vulnerable leader, Nicholas Sarkozy, who lost re-election to François Hollande. Thus, the French case provides an opportunity to examine behaviors of a politically vulnerable leader and a newly elected leader in the same country.

Finally, we focus on Greece as a juxtaposition to Germany and France. Greece was one of the hardest hit countries in the GFC, and its recovery has been the most difficult. Consequently, Greece has had five different leaders between 2008 and 2014, only one of which enjoyed any kind of political stability. Thus, we see all three cases as excellent examples of our theoretical approach.

We implement a qualitative case-study analysis focusing on news sources for data. To gather our sources, we ran a LexisNexis Academic search to gather a sample of news sources from 1 January 2008 through 22 October 2014. We searched within English language, major world publications to capture the largest sample of

[15] J. Bibow, "At The Crossroads: The Euro and Its Central Bank Guardian (and Savior?)," *Levy Institute of Bard College*, no. 738 (2012): 1-24.
[16] "One woman to rule them all," *The Economist*, September 14, 2013.
[17] A. Evans-Pritchard, "IMF: global economy faces a threatening downward spiral," *The Telegraph*, 2011.

credible news agencies and to control for any potential bias between publications of various geographic origin or political leaning.

To construct our sample, we searched for key terms related to primary concepts in our study, and we narrowed the sample to focus on the most relevant documents. First, we discarded documents that were not directly relevant to the Eurozone crisis or the ECB. Then, we eliminated documents without specific references to political leaders by name. Ultimately, these efforts left us with a sample of 16 total documents—six for Germany, four for France, and six for Greece.

Using this sample, we conducted a content analysis of our key independent variable and our key dependent variable to determine the relationship between the level of optimism expressed and its impact on the legitimacy of the ECB. To find indicators of the level of political *optimism*, our independent variable, we looked for positive or negative statements from political leaders about the economic or political status of their country or the EMU. In some cases, we substituted third-party commentary on the leaders' tone when direct quotes were not available; negative tone suggested low levels of political optimism whereas positive tone suggested high levels of political optimism.

For *central bank legitimacy,* our dependent variable, we looked for statements that emphasized de jure or de facto independence of the ECB. First, we focused on *institutional independence*, which is a form of legal independence that measures prohibition of external influence on central banks in the form of taking or seeking instruction from external institutions or from government officials. Second, we focused on *personnel independence*, which refers to the rate of turnover of central bank governors. Finally, we focused on *financial independence*, which refers to budgetary independence of central banks. Any or all of these three measures were used to assess the conditions under which leaders were seeking to legitimize or delegitimize these activities by the ECB.

The Legitimacy of the ECB

In all cases, we see evidence that politically optimistic leaders will be more likely to offer statements legitimizing the work of the ECB and that less-optimistic leaders will be less likely to offer statements of support.

In the case of Germany, two articles show optimism is directly tied to statements that legitimize the actions of the ECB. In the first article, Merkel expresses the positive benefits of Germany's adoption of the euro while calling for more policy control, or institutional independence, for the ECB.[18] In the second, Merkel, whose "popularity at home is undimmed," calls for the ECB to have more policy control over the bailouts in Cyprus, which also corresponds to institutional independence.[19] In both of these examples, we see Chancellor Merkel's optimism corresponds to her calls for increased institutional independence for the ECB, which supports our first hypothesis.

The second set of examples support our second hypothesis that less optimism will be accompanied by statements that seek to delegitimize the work of the politically independent ECB. The first article notes that Merkel's "popularity has sunk to its lowest level in nearly five years" and that she is vehemently opposed to the sale of Eurobonds, which would provide increased financial independence for the ECB.[20] In the second example, Merkel is facing potential "backlash from German voters" which has made her "reluctant" to support a common banking supervision system under the ECB.[21] Here, her lack of optimism about her political future in 2011 made her reluctant to support a measure that would increase the institutional independence of the ECB. In these two cases we seek a lack of political optimism tied to statements that seek to delegitimize the independent

[18] S. O'Grady and V. Mock, "Banks forced to share pain of bailout for Greece; Relief across Europe as deal on Greek debt is finally agreed," *The Independent*, 2011.
[19] D. Charter, "Angela Merkel banks on keeping voters happy," *The Times*, 2013.
[20] N. Barkin and G. Heller, "Germany's Eurobond debate heats up; Pressure grows; 'Downward spiral' threat to economies," *The Gazette*, Montreal, 2011.
[21] K. Maley, "Merkel bank stand spooks investors," *Australian Financial Review*, 2012.

functioning of the ECB.

We see similar results in two articles from 2014. In both cases, Merkel is less optimistic about her political future given the rise of the anti-euro party called Alternative for Deutschland, which "has drained votes from the Christian Democratic Union party of Ms. Merkel."[22] In the first article, we see Merkel criticizing the recent bond purchases by the ECB while simultaneously feeling political pressure from the recent rise of the anti-euro party in Germany.[23] Then, in the second article, Merkel is seen as "stumbling" from the rise of the Alternative for Deutschland party while simultaneously showing opposition to stimulus measures the ECB is hoping to deploy. Holger Schieding, chief economist in London for Berenberg bank is quoted as saying: "'German resistance against the ECB pursuing more aggressive policy is one of the things spooking markets.'"[24] In both cases, Merkel is clearly indicating a lack of support for the work of the ECB as she faces increasing opposition at home, which supports our second hypothesis. Altogether, these examples from Merkel provide direct support for our argument about the impact of the degree of optimism on the legitimization of the ECB.

In the case of France, we examine two different leaders. First, we look at President Nicholas Sarkozy who served as President of France from May 2007 until May 2012. Next, we look at President François Hollande, who has served as President of France since May 2012. In examining the attitudes of both leaders, we find support for our argument.

For Sarkozy, we found two articles addressing the ECB. In the first, from 22 July 2011, we see a positive link between optimism and support for the ECB, which supports our first hypothesis. Sarkozy "heralded" giving more financial powers to the ECB so as to quicken "the pace of what he called 'European economic governance'."[25] Here, Sarkozy's optimism is linked to his push for more policy power for the ECB, which is a positive reflection on the ECB's institutional independence.

In the second article, dated 22 October 2011, we find support for our second hypothesis. Here, Sarkozy is described as demanding French leadership in the ECB and is noted as being on the verge of "fury" and "anger."[26] This article suggests that Sarkozy is waning in optimism and thus unwilling to allow the ECB to select its own leaders, which sends a clear signal that the ECB is not a legitimate actor in the eyes of the French government. Therefore, in the two examples from President Sarkozy, we see evidence supporting both of our hypotheses.

In the second French case, that of President François Hollande, we find two articles connecting him to the ECB. In the first article, we find support for our first hypothesis. Here, Hollande, who was just recently elected and thus not electorally vulnerable, is pushing for a closer banking union and additional banking supervision of the Eurozone countries under the ECB.[27] This push for institutional independence confirms our argument that politically optimistic leaders will seek to boost the legitimacy of the independent central bank.

In the second article, from 2014, we see a much different perspective from Hollande. Here, Hollande's approval rating has fallen to 17%, and "the odds would currently seem to be against the sitting president."[28] In this case, we see Hollande remaining "one of the key advocates of a looser approach to the austerity and fiscal orthodoxy guarded and promoted by Merkel and the ECB."[29] Thus, this article

[22] J. Yardley and J. Ewing, "Large Nations in Europe Balk at German Gospel of Austerity," *The New York Times*, 17 October 2014.
[23] "ECB policies criticized by Merkel," *The Irish Independent*, 22 May 2014.
[24] J. Yardley and J. Ewing, "Large Nations in Europe Balk at German Gospel of Austerity," *The New York Times*, 17 October 2014.
[25] S. O'Grady and V. Mock, *The Independent*.
[26] N. Squires, "Berlusconi in Sarkozy bank snub," *The Daily Telegraph*, 2011.
[27] L. Armitstead and B. Waterfield, "EU Summit: Angela Merkel moves to block Hollande bank union deadline," *The Telegraph*, 2012.
[28] M. Kettle, "Hollande may yet play role in Europe: Even though he lacks popularity at home, the French PM is in the right place to challenge Angela Merkel and German orthodoxy," *The Guardian Weekly* (5 September 2014).
[29] M. Kettle, *The Guardian Weekly*, 5 September

suggests that as Hollande's approval continues to drop, he will continue to distance himself from the policies of the ECB and issue statements that delegitimize the role of the ECB in monetary and financial affairs. Again, we see evidence of our argument that political elites who feel less optimistic about their chances of reelection will seek to delegitimize the ECB.

In the case of Greece, we find articles for three of the five prime ministers who served from 2008-2014. First, we have three cases from George Papandreou who was an unpopular leader from October 2009-November 2011. Next, we find two cases from Lucas Papademos who was an appointed prime minister from November 2011-May 2012. Finally, we have two examples from Antonis Samaras who was prime minister from June 2012-January 2015. In all examples, we find support for our argument.

In the examples from Papandreou, we find evidence of a leader who is not optimistic about his time in office and therefore favors pulling back independence from the ECB.[30] Specifically, Papandreou advocated for a public vote on bailout packages, which shows his lack of concern for the political independence of the ECB.[31] These examples confirm our hypothesis that political leaders who lack optimism will seek to take back power from the ECB.

Next, in the examples from Papademos, we find a political leader who is unconcerned with his tenure in office and is thus supportive of the ECB.[32] Papademos was appointed as an interim prime minister and thus had no reason to concern himself with political vulnerability. He regularly advocated for full implementation of the policies of the ECB, including spending cuts, repaying public debt, and eventually allowing the default to take effect.[33] These examples provide unique insight into our argument to a leader who is not concerned with political vulnerability and will continue to legitimize the institutional independence of the ECB.

Finally, we examine the tenure of Antonis Samaras, who was the first prime minister to win a general election since 2011. We see evidence he is very negative about the future of the Greek economy as debt was still over 150% of gross domestic product (GDP). Consequently, Samaras was arguing the northern EU countries should be held responsible for the crisis and Greece deserved a two-year extension on austerity measures.[34,35] Again, we see evidence of a politically vulnerable leader who is pessimistic about the national economy call for measures decreasing the legitimacy of the ECB.

Overall, these examples provide strong support for our argument linking optimism and central bank legitimacy in the areas of institutional, personnel, and financial independence. This is an important step in demonstrating how optimism can link political and economic policy spheres and the small, but meaningful, ways legitimacy can be granted to or chipped away from the ECB, particularly in the areas of policy, personnel, and finance.

Conclusion

For central banking systems, like the EMU, to work effectively, all members must cooperate. However, the GIIPS countries effectively broke their financial and monetary agreements with the rest of the EMU.[36] Now, political elites throughout the Eurozone and within the ECB must make the difficult decision to cooperate on

2014.

[30] B. Milner, "Europe's governments prepare to take their medicine," *The Globe and Mail* (Canada), 7 November 2011.

[31] H. Smith, "Lucas Papademos to lead Greece's interim coalition government," *The Guardian* (London, England), 10 November 2011.

[32] J. Ewing, "Papademos is known for acumen, not for flash; New leader is considered a political outsider, but that could be an asset," *The International Herald Tribune* (New York), 11 November 2011.

[33] C. Haritos, "World: I fear for a social explosion: Greeks can't take any more punishment: Helena Smith, who has reported from Athens for more than 20 years, says the country is falling apart at the seams as it desperately tries to solve its debt crisis," *The Observer* (England), 12 February 2012.

[34] J. Hurley, "'Worst is over' claims Greece as IMF backs country reforms," *The Sunday Telegraph* (London, England), 5 May 2013.

[35] "Eurozone crisis: Greek PM asks for more time to implement cuts," *The Scotsman* (Edinburg, Scotland), 22 August 2012.

[36] A. Moravcsik, *New York Times*.

behalf of and with these countries to preserve the broader economic structure.

In this paper, we sought to determine conditions under which political leaders will support or undermine the legitimacy of independent central banks in the aftermath of economic crises. Our findings revealed more optimistic leaders have demonstrated a willingness to support efforts that give more responsibility to the ECB to manage and resolve the economic crisis. Thus, optimism is directly connected to the legitimacy of the ECB.

Unfortunately for Europe, the current economic climate remains tenuous as growth remains slow throughout the Eurozone, and political leaders throughout the EMU are increasingly less optimistic about the direction of the European economy. Calls for new directions in monetary and financial policy continue to come from key leaders, including Merkel[37] and Hollande,[38] as do threats to curb the ECB's role. These attitudes signal that recovery from the Eurozone crisis may be farther away than hoped for, which demonstrates the continued need for optimism among political leadership to spur economic recovery.

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[37] Neil Irwin, "The Conflict Between Germany and the E.C.B. That Threatens Europe", *The New York Times*, 24 October 2014

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