THE WORLD'S MAJOR CENTRAL BANKS HAVE GAINED MUCH MORE POWER SINCE THE FINANCIAL CRISIS. ARE THEY NOW TOO POWERFUL?

THE GOVERNANCE OF MONETARY AND FINANCIAL STABILITY POLICY

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SINCE THE FINANCIAL CRISIS, the world's major central banks have accumulated much more power. Is that OK? Does it fit with our democratic values? The delegation of power by legislatures surely needs to do so if central bank independence, and even confidence in our system of government itself, is to be sustained.

Compared with the response to the 20th century's Great Depression, when elected politicians did the heavy lifting, this time central banks led the way in reviving the economy and redesigning the international financial system. They used their balance sheets on a gigantic scale to influence credit conditions, steering the allocation of resources and taking risk in ways that blurred the boundary between them and the elected fiscal authorities.

This has not been uncontroversial. In the U.S., the Federal Reserve has yet to shed the perception, fair or unfair, that it overstepped the mark in some of its crisis-fighting measures a decade ago. In Asia, the Bank of Japan sits, in close partnership with its government, in the antechamber to monetizing the country's vast debt. And in Europe, where the European Central Bank's (ECB) actions have been challenged in the highest courts, the central bank effectively has been the existential guarantor of the Project of "ever closer union" it serves – an accidental economic sovereign in an incomplete constitutional structure.

What's more, the major central banks have been given lots of new regulatory powers, both microprudential and macroprudential. In some jurisdictions, including the U.S., they are obviously the body to which everyone would look when things turn nasty again. In others – notably, Britain – the central bank is formally the veritable leader of stability policy. More or less everywhere, central banks

are now unambiguously part of the regulatory state as well as the fiscal state.

Alongside activist judges, central bankers have, indeed, become the poster boys and girls of unelected power. It is hardly surprising, then, that more people have been asking whether the insulation of the monetary authorities from day-to-day political influence can still be justified.

This is symptomatic of much broader, growing concerns about our system of government: how to avoid a desperate choice between *technocracy* and *populism*. On one hand, independent central banks and regulatory agencies can sometimes achieve better results by avoiding the swings in public policy associated with electoral politics. On the other hand, excessive delegation-with-political insulation would take us toward a form of undemocratic liberalism – government in which many of the big choices affecting our lives are made by unelected technocrats subject only to judicial policing, which some believe is where we are headed given the disciplines of a globalized market economy.

In *Unelected Power*, published by Princeton University Press in May, I try to make sense of these issues, proposing precepts that, if they became accepted as political norms, could legitimize the extraordinary power of the central banks (and other independent regulators) and so make it safe for our democracies.[1]

Although this oversimplifies the book's argument, one of its underlying themes is that a certain type of liberalism, centered on legal formalism and judicial oversight, is insufficient to give legitimacy to our unelected policymakers. If we are serious about our democratic values and heritage, it is not enough that decisions to delegate are taken by properly elected legislatures if they set only vague (and/or multiple) objectives that leave unelected technocrats as the true makers of high policy.

Nor is it enough for the exercise of delegated powers to be overseen by judges, enforcing procedural standards and sometimes substituting their own view of policy after reviewing the substantive merits of agencies' decisions and actions. In that reasonable approximation of the real world, there are no limits to what may be delegated, only the need to satisfy the courts that power has not been abused. This kind of thinned-out legal liberalism shortchanges our democratic values, and so is liable – albeit in slow motion – to jeopardize support for our democratic system of government.

INSULATED TECHNOCRATS UNDER DEMOCRACY

These aren't abstract issues, of interest only to aficionados of economic policy or government design. There can be little doubt that unconstrained unelected power could be a hell of a problem. Imagine an independent agency that had lots of powers but only the vaguest purpose and objective(s). Who would be able to tell whether it had succeeded in its mission if it set its own goalposts? Just as "no taxation without representation" was a rallying cry a couple of centuries' ago, why don't we today demand "no regulation without representation"? Or, more accurately, why don't we demand that elected legislators set high policy (i.e., its key parameters) when they delegate powers to independent agencies?[2]

In particular, if attacks from the left and right on the Fed and other monetary authorities might sometimes seem impractical to central bankers, they nevertheless should take seriously the complaint that the limits on their powers and actions are not principled.

THE PRINCIPLES FOR DELEGATION

For our democracies to remain healthy and resilient, then, we need norms for *whether* and *how* to delegate to independent agencies – principles that measure up to the deep political values associated with democracy, the rule of law, and constitutionalism. *Unelected Power* proposes and defends just such a set of Principles for Delegation.

Among the most important are:

- **Power should be delegated to agencies insulated from day-to-day politics only where the public's goals are broadly settled, better results could be achieved via enhanced credibility, and the technocrats don't have to make big choices on values and distributional issues.**

- **Elected politicians should give such agencies an objective that is sufficiently clear for monitoring to be reasonably straightforward,**

and with that oversight led by the assembly itself as part of deciding whether to maintain the delegation.

- The agency's exercise of discretion should be systematic, guided by published operating principles.
- Decisions should be taken by one-person, one-vote committees, after deliberation.
- Where, as with the post-crisis central banks, an independent agency has multiple missions, each should be the responsibility of a distinct policy body within the agency, with a majority of every committee's members serving on only that body.

Each of today's central banking functions – monetary policy, stability policy, supervision of individual banks, emergency liquidity provision – should be shaped and constrained by something like those Principles for Delegation. Few would be left untouched. To give only obvious examples, in Europe the ECB's decision-making body is too big (25 voting members) to be deliberative, as might be the Fed's Open Market Committee (12 voting members, plus seven regional presidents who speak but don't vote). The Fed has also specified its own inflation objective, without much public debate.

MONETARY POLICY INDEPENDENCE

Nevertheless, in varying degrees, monetary policy regimes in the major democracies mostly live up to the broad spirit of those Principles. Everywhere, transparency has increased massively. Notably, through the spread of a regime known as "inflation targeting," as the 1990s progressed both the outputs of policy (a short-term interest rate) and its outcomes (inflation) became hugely more visible and comprehensible to members of the public and their legislators. Even in the U.S., the Fed eventually took the step, under Chairman Ben Bernanke, of publishing its understanding of "stable prices" and "maximum employment," the two components of its statutory purpose.

Partly for those reasons and partly because it seemed to work, granting independence to monetary authorities became the rage during the 1990s, eventually being institutionalized via International Monetary Fund

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advocacy and conditionality. Twenty years on, all that sometimes seems to be up for grabs again.

IS MONETARY INDEPENDENCE PASSÉ?

The most elevated critique from within the economics profession is that the inflation problem was a quirk, albeit a serious one, of the 1970s; that the battle against inflation is won; and that today's challenges of low productivity growth and debt overhang could be met more effectively by having all macroeconomic policy instruments in one set of (political) hands, lifting artificial barriers to a joined-up monetary-fiscal strategy. In short, the circumstances warranting monetary independence are behind us; the moment for fastidious adherence to separate monetary and fiscal spheres has passed.

One problem with these arguments is that they implicitly assume that the case for independence rested solely on an inflation bias sourced in what economists call a time-inconsistency problem: the policymaker having incentives to break promises to deliver price stability in order to allow a little more growth and jobs today. The difficulty in committing to a systematic monetary policy goes broader and deeper than that.[3]

Whatever central bankers' private preferences, their legal duty in early 2009 – to pursue their statutory mandate but not more than that – was clear: provide stimulus to spending in order to avoid deflation and so preserve price stability. It is hard to believe that elected monetary policymakers would have been as ready or as able to deliver the extraordinary stimulus that helped circumvent economic depression a decade ago.

They might well not have been *ready* because the measures taken – entailing persistently low returns on savings products

– were unpopular with vocal parts of the electorate. Even if policymakers had been willing, they might well have proved *unable* to provide the necessary but still limited stimulus. It is unlikely that politicians controlling the monetary levers would have been trusted to resist the temptation of going further and inflating away the burden of government debt via a burst of inflation. In short, day-to-day political control of monetary policy would have carried risks of both underreaction and overreaction to the economic crisis.

The missions of preserving banking stability and price stability are intertwined – not only for society but also for the central banks themselves in their most elemental function: **creating money.**

This is not just about economics. Putting the power of the inflation tax in the hands of the elected executive branch would violate the separation of powers that lies at the heart of the West's system of constitutional democracy. It is not often said, but independent monetary authorities are an institutional device for avoiding the volatility in output and jobs associated with an anchor like the 19th century Gold Standard – volatility unlikely to be acceptable under full-franchise democracy – without side-stepping our constitutionalist values.

STABILITY POLICY

But if the warrant for monetary independence narrowly conceived runs deeper than was perhaps visible during the inflationary 1970s and '80s, why should the central bankers now become leaders for the broader purpose of preserving financial stability? The answer goes to the very heart of what a central bank is: *Central banks are inalienably involved in stability policy – a de jure function entails a de facto function.*

The issuer of an economy's money can do something that no one else can do: create money at will. When there are sudden shifts in the demand for its money, the monetary authority must accommodate those demands if it is to avoid inadvertent restraint on (or stimulus to) economic activity. Runs on the banking system – people demanding that their deposits be redeemed in cash, *right now* – amount to increases in demand for a central bank's money. If even otherwise sound banks do not hold sufficient central bank money (or assets that can be converted into central bank money via the market) to meet their customers' demand for cash, they will fail unless they can go to the central bank and exchange illiquid assets for cash. Assuming the central bank agrees, it is doing two things at the same time. It is stabilizing banking by acting as a lender of last resort (LOLR), and it is ensuring that the liquidity crunch does not interfere with the course of monetary policy.

This runs deep. At an architectural level, we have a monetary-cum-banking system that, seeking efficiency (and, perhaps over time, fairness), separates the allocation of credit from the state but does not confine the money-creation power to the state, instead allowing private firms to issue monetary liabilities. This system of fractional reserve banking blends the payments system (money) and the credit system (loans) without making them completely coterminous.

Banks are part of the monetary system, and so also in effect are ""non-bank banks" as they used to be known or "shadow banks," as we now call them, that have the economic substance of banking but not its legal form. Hence, the missions of preserving banking stability and price stability are intimately intertwined – not only for society but also for the central banks themselves in their most elemental function: creating money.

FORMALIZING AND LIMITING THE LOLR

An elemental function can still be controversial, however, as the financial crisis made amply clear. Central banks are celebrated and castigated in broadly equal measure for the actions they took (or did not take) to stabilize the financial system and wider economy when crisis broke in 2007 and spread through 2008. For every paean of praise for their innovations in injecting liquidity and keeping markets open (barely), there is a chorus of reproof censuring central banks for breaching a crucial boundary between central banking and fiscal policy.

Assessed against *Unelected Power*'s precepts for how to delegate to an independent agency, there were problems on just about every front:

- **Boundaries for the LOLR function were often not clear.**

- **Nor, before the heat of battle, were the principles that would guide central banks in exercising discretion.**

- **Decisions were not always taken by committee (notably, in the U.K.).**

- **It was hard for elected representatives to monitor what was going on, partly because of the sheer speed, scale, and complexity of events, and partly because public disclosure could have exacerbated the crisis the monetary authorities were desperately trying to contain.**

- **It was not always clear when and how central banks should seek and obtain political authority without compromising monetary independence.**

Although in some jurisdictions there were laws and/or codes that had been agreed with the elected executive or legislative branch, they proved incomplete, to put it mildly.

This has led to confused debate, focused so much on constraints that – perhaps especially in the U.S. – the public policy purpose all too easily slips from view. Specifying in legislation that the Fed must maintain "an elastic currency" does not suffice, not least because those words must be incomprehensible to almost everyone.

It needs to be reaffirmed by elected politicians that central banks will act as the LOLR, in pursuit of a clear statutory purpose. That purpose should be to avoid or mitigate the social costs that flow from illiquid but fundamentally sound intermediaries failing in a disorderly way or rationing credit and other services (in order to serve the intermediaries' private interest in staying alive).

But there must also be constraints. Most vitally, just as "no monetary financing" of government is necessary to secure an independent monetary policy, a cardinal principle for an independent LOLR must be: *No lending to fundamentally insolvent firms.*

Where an ailing firm is fundamentally bust, extending liquidity assistance simply permits short-term creditors to escape intact (be "bailed out") at the expense of longer-term creditors without preventing the firm's eventual closure. That is, emphatically, not the purpose of central banking.

Given recent advances in statutory regimes for resolving unsound firms without taxpayer solvency support, today's central bankers have no reason to be more lax than their 19th century predecessors, who famously turned away fundamentally bust firms seeking access to the Window.[4] LOLR assistance is conceptually distinct from, and in practice can now truly avoid being, a bailout or rescue of fundamentally unsound firms. The breakthrough in resolution technology is nothing short of transformative for the LOLR, because central banks can say 'no' when they should.

THE LOLR AND STABILITY POLICY

If central banks are unavoidably the lenders of last resort, it follows that they need to be involved in regulation and supervision. Most basically, when they lend, they want to get their money back! They need to be able to judge which banks (and possibly near-banks) should get access to liquidity, and on what terms: the source of their historical pragmatic authority over banking. Even opponents of "broad central banking" generally accept that, as the lender of last resort, the central bank cannot avoid inspecting banks that want to borrow. Events in the U.K. during 2007, when Northern Rock hit problems but the central bank was not a supervisor, demonstrated that gearing up to be the LOLR from a standing-start is hazardous for society. A central bank must be in a position to track the health of individual banks during peacetime if it is to be equipped to act as the liquidity cavalry; and, more broadly, if it is to be in a position to make reasonable judgments on how its monetary decisions will be transmitted through the financial system to the wider economy.

The role of central banks in supervision and regulation should be formalized but also *limited*. That last bit is no small matter given the realm of financial regulation historically extends well beyond what is needed to preserve "stability." Should central banks lean against each and every credit or asset-price bubble they

think they see, for example? If they go down that road, how could we monitor whether they were doing too much or too little?

A STANDARD FOR SYSTEM RESILIENCE

In *Unelected Power*, I argue that the solution is to focus stability policy on the need to maintain a resilient financial system that can continue functioning in the event of bankruptcies and distress – that's to say, a financial system that can maintain the provision of the core services of payments transfers, credit, and insurance.

This side-steps the imponderable difficulty of defining, and hence of measuring and monitoring, "financial stability" or "instability." Taking into account barriers to entry and the effectiveness of special resolution regimes, elected politicians should decide (or bless) general policy on how resilient core intermediaries and infrastructure are required to be: a standard of resilience.

The microsupervisory task of ensuring the "safety and soundness" of individual firms would be recast (or, short of legislative change, interpreted) in that light, making real the slogan that supervisors don't aim for a zero-failure regime.

To make the objective monitorable, the unelected supervisors would publicly reveal whether the desired standard of system resilience was being achieved. Serious stress testing, an incredibly important innovation taken by the U.S. authorities in the spring of 2009, puts today's supervisors in a position to do just that. If rigorous, it can help to reduce the socially destructive risk of capture by the industry and its penumbra of lobbyists.

JOINED-UP CENTRAL BANKING UNDER A *MONEY-CREDIT* CONSTITUTION

What I have sketched would amount to the central bank being given a mandate to maintain the stability of the *monetary system*. It has two components: stability in the value of central bank money in terms of goods and services (low and stable inflation); and, second, stability of private monetary liabilities in terms of central bank money.

That mandate would, on the view presented in *Unelected Power*, form part of a "Money-Credit Constitution," which would also specify constraints on the business and risks in banking (including shadow banking), and on the central bank itself.

Central banks would stay out of a number of areas. They do not need to, and so should not, take on responsibility for competition policy, the structure of the financial-services industry (as it involves high-level trade-offs between efficiency and resilience), its external competitiveness (as that invites political pressure to adopt "light-touch regulation"), consumer protection, and market regulation. Staying out of those fields is not yet the norm for central banking across the major democracies.

Closer to home, central banks should not intervene to cure those market malfunctions and excesses (including some asset-price booms) that distort the efficient allocation of resources in the economy but do not materially jeopardize the financial system's resilience. So, they would not seek actively to manage the credit conditions facing different sectors or regions, not least because that would entail their making distributional choices. Big picture, this would also limit the scope of what has become known as "credit policy" – using central bank balance sheets to steer the supply of credit– which I elaborate upon in *Unelected Power.*

MULTIPLE-MISSION CENTRAL BANKS: SEPARATE COMMITTEES

If central banking as I espouse it is to be effective as well as joined up, central bankers must have incentives to take seriously every one of their various functions rather than prioritizing the area that is most salient with the public and their representatives or that gives central bank leaders the greatest personal rewards in terms of professional prestige. If those risks were to crystallize, ambitious staffers would want to work in the sexiest area, depleting the human capital available to the central bank's other functions. In the decade or so before the financial crisis, that risk seemed to crystallize in the Greenspan Fed. And worries about it, reflected in once-fashionable New-Public-Management doctrines, helped to motivate the decision to detach formal responsibility for banking stability from the Bank of England in the late-1990s.

The solution is for each mission (monetary policy, microsupervision, etc.) to have its own policy committee, and for each of those committees to have a majority of members who do not serve on others so that they are focused. The

role of the chair is reconfigured away from being a sort of guru to ensuring that the whole operates efficiently. Each responsibility gets the effort it deserves, in a joined-up way.

A version of that structure was introduced in the U.K. in 2012, with separate Bank of England committees for monetary policy, macroprudential policy, and bank supervision. It is approximated, but not quite realized, in the ECB and the Fed. Congress creating a vice chair for supervision and regulation in the United States certainly helps.

THE GRAND DILEMMA OF CENTRAL BANKING

Can this meet the problem of central banks having become the only game in town? In part, yes, because clarity over the boundaries of central banking might help to generate self-restraint. But that might not suffice given the nature of the underlying problem.

There is a strategic tension between central banks and elected fiscal policymakers, who face few constraints on their powers but carry equally few legal obligations. In consequence, when short-term politics stand in the way of politicians acting to contain a crisis or bring about economic recovery, they can sit on their hands safe in the knowledge that their central bank will be obliged by its mandate to try.

Here, then, is the grand dilemma of central banking. In the interests of democratic legitimacy (or, put another way, to avoid accusations that they have overreached themselves), central bankers need clear regimes, with objectives for all of their functions. But the articulation of such regimes risks exacerbating the strategic interaction with the fiscal authorities, leaving them as the only game in town and as potentially over-mighty citizens of whom too much is expected.

Today, there is no off-the-shelf solution. A central bank regime for all seasons cannot be designed without a good fiscal constitution existing too. Setting boundaries to the authority of central banking needs to factor in what is on the other side of the border. Solving that problem is likely to take a generation. In the meantime, the central bankers need to resist pressures to encroach too far into fiscal territory. That is likely to become apparent when the next recession arrives, as it surely will. The deep underlying challenge is around legislators, not central bankers.

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CONCLUSION

Around the world – most obviously in the U.S. and continental Europe – the permissible extent of central bank power is being debated again. This is not some isolated thing but is part and parcel of broader discomfort with the reach and scale of delegated technocratic governance. Those who express concern about populism would do well to turn part of their attention to how to keep technocracy within safe and proper limits.

Facing up to this will mean embedding means for combining the benefits of credible commitment (the key social benefit of delegation-with-insulation) with constraints on functions, objectives, and processes that recognize our deep political values and traditions. Because every part of government goes wrong eventually and because people are likely to react especially badly when let down by their unelected governors, it is worth the effort.

Most of all, the solution will involve finding a way back to political norms that align the incentives of legislators with our democratic values. Ultimately, this is all about what we expect of our elected representatives. ■

ENDNOTES

1. *Unelected Power: The Quest for Legitimacy in Central Banking and the Regulatory State.* Copyright © 2018 by Paul Tucker. Published by Princeton University Press. Reprinted by permission.
2. *Unelected Power* is mainly about agencies that are insulated from both elected branches of government – i.e., in the U.S. those agencies that, among other things, are not subject to annual budget approvals from Congress. Rather misleadingly, U.S. legal scholars typically use the expression "independent agency" more narrowly to mean insulation from the president.
3. Some of these points, without the constitutionalist framing, are made in Ben Bernanke's "Monetary Policy in a New Era." Peterson Institute for International Economics, October 2, 2017.
4. The most famous case is the Bank of England saying "no" to Overend, Gurney and Co. in 1866.