INSIDE STORY

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A BANKER'S QUEST FOR LEGITIMACY

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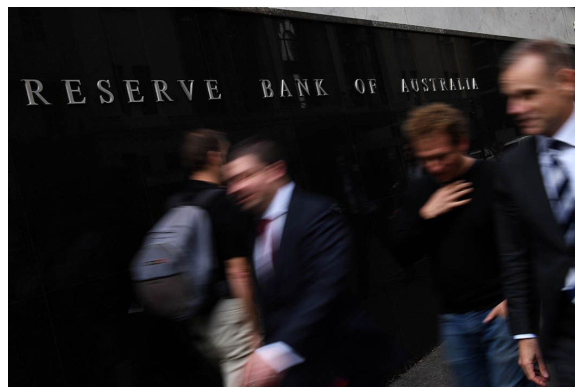
Books | A former Bank of England official offers a warning about unelected decision-makers that Australia might already have heeded



Right:

Handling "unelected power" better than most? The Sydney headquarters of Australia's Reserve Bank.

Unelected Power: The Quest for Legitimacy in Central Banking and the Regulatory State
By Paul Tucker | *Princeton University Press* | $66.95 | 654 pages

Paul Volcker, the greatest chairman of the US Federal Reserve, declared that "an effective central bank must be a strong central bank, with substantial autonomy in its operations and with insulation from partisan and passing political pressures." Yet he was also "a strong advocate of the independence of central banks within government," convinced that "the ability to reach independent judgements about monetary policy must not imply isolation."

Many would support Volcker's position. Regulatory agencies that exercise unelected power, including central banks, need to legitimise their authority by showing a willingness to communicate with the public, and their powers, responsibilities and actions need to be endorsed by the elected representatives of the country according to liberal democratic principles.

How — and in what circumstances — elected representatives should delegate their responsibilities to independent agencies is the subject of this outstanding 650-page treatise, written by a former deputy governor of the Bank of England. When he made the decision to retire from the Bank of England in 2013, Sir Paul Tucker was in charge of financial stability and sat on the bank's monetary policy, financial stability policy and prudential policy committees. He left the bank shortly after Mark Carney, the then governor of the Bank of Canada, was appointed governor of the Bank of England. Tucker is now a senior fellow at both the Harvard Business School and the Mossavar-Rahmani Center for Business and Government at Harvard's Kennedy School for Public Policy.

Asked in a recent interview what prompted him to write *Unelected Power*, Tucker recounted how he had been deeply troubled by the potential for public policy to be set by independent agencies rather than by parliaments and governments. He wanted to explain "why I, and others among the Bank of England's then leaders, leaned against some of the regulatory powers people wanted us to have after the Great Financial Crisis, and why we pressed for quite demanding substantive and structural constraints on the new powers that were conferred. In a nutshell, we didn't want to be over-mighty citizens."

Tucker also wanted to "express unease about the much more fundamental issue of our societies' drift towards Technocracy through the delegation of more and more government power to unelected regulators, central bankers, activist judges — taking us toward a form of undemocratic liberalism." The book, he continued, "is really a paean to the virtues of representative democracy, and a plea to our legislators to get properly involved again in government by giving regulatory agencies clear objectives that can be monitored."

Of course, there may be good reasons for bringing in technical experts to design and implement policy, especially in the area of central banking. Elected representatives are often tempted to pursue policies designed to shore up their electoral standing rather than advance the public interest. For Tucker, the problem lies in the tension between legitimacy and credibility: while elected officials enjoy legitimacy but often lack credibility, central banks may possess credibility but have tenuous legitimacy — in the sense that their functions and operations do not derive directly from the democratic process in the way that the government's fiscal policy does.

A key theme of *Unelected Power* is that central banks can acquire greater legitimacy by taking care not to exceed their mandate, by being transparent and ready to explain the reasons for their actions, and by engaging in public debate. The book amounts to "a series of reflections on how advanced-economy democratic societies could address the question of legitimacy presented by the prevalence of independent agencies." To be legitimate as well as credible, elected representatives need to establish clear objectives for independent agencies to follow, and to endorse their operating procedures and monitor their actions. The agencies themselves need to explain and justify their operations. In short, "the central bank's mandate and powers should be clearly and carefully delineated… [W]e want functional, democratically elected, and accountable legislatures but definitely not unelected over-mighty citizens."

This leads to one of the book's most arresting contributions. Tucker sets out, in considerable detail, what he calls the Principles for Delegation to Independent Agencies, which address "the importance of clarity around whether or not an agency should be independent and how to structure its insulation." He contends that a "public policy regime should be entrusted to an independent agency insulated from day-to-day politics of both elected branches of government only after wide public debate" and only if a number of principles are observed. Independent agencies should have "clear, monitorable objectives"; they "should not be given mandates that entail making big distributional choices or big value judgements on behalf of society, and their policy choices should not interfere with individuals more than is warranted to achieve their statutory purpose"; "governments and legislatures should articulate in

advance, and preferably in law, how (if at all) an independent agency's powers to intervene in an emergency would be extended"; the "provisions of... delegation should, in the usual course of things, be laid down in ordinary legislation, embedded through public support and usage"; these "principles should be exposed to national public debate"; and the leaders of independent agencies "should work under an ethic of self-restraint." As a more recent chairman of the Federal Reserve, Ben Bernanke, expressed it, central banks should exercise "constrained discretion."

In *Unelected Power*, Paul Tucker draws attention to an issue of great contemporary significance. In recent times, the presidents of the United States and Turkey have questioned the legitimacy of policies foreshadowed by the heads of their countries' central banks. Given the nature of contemporary political discourse and trends in the character of political leadership, it is likely that doubts will continue to be expressed about the legitimacy of unelected centres of power in modern democratic societies, including central banks. This is even more likely to happen if another global financial crisis occurs in the not-too-distant future.

Throughout the book, Tucker expresses his disappointment that political theorists in recent times, with some notable exceptions, have generally avoided the subject of unelected power. But this was not necessarily the case in the past. Tucker himself refers to some of the ideas expressed in the United States by Alexander Hamilton, Thomas Jefferson and James Madison. But economic historians will no doubt lament his limited coverage of the evolution of central bank independence in practice, which also mainly deals with the United States, Britain and other EU countries. This is to be expected, but it may be of interest here to mention briefly some aspects of the development of central bank independence in Australia.

Until the depression of the 1930s, the Commonwealth Bank (forerunner of the Reserve Bank) acted as a central bank in very limited ways. On the few occasions it attempted to conduct monetary policy, it did so without much direction from the government. The first act of deliberate monetary policy — aimed at returning Australia to the gold standard in the first half of the 1920s — was initiated by the Notes Board, an independent statutory authority chaired by the governor of the Commonwealth Bank and administered by the bank. Though ultimately successful in its aim, the deflationary policy executed by the Notes Board was condemned by exporters, and eventually the authority was abolished. During the depression, the chairman of the Commonwealth Bank board, Sir Robert Gibson, clashed repeatedly with government over exchange rate policy, interest rates and the funding of budget deficits. For the first ten years or so of central banking in Australia, the Commonwealth Bank appeared able to act independently of the government, but whether it used its independence wisely — and with "constrained discretion" — is debatable.

In the mid 1930s, dissatisfaction with these early attempts at central banking led to the creation of a royal commission into Australia's monetary and banking systems. Central bank independence was one of the questions that attracted the commission's attention. In its view, where a dispute arose between the bank and the government, the parties should attempt to resolve the problem through "full and frank discussion." But in "cases in which it is clear beyond doubt that the differences are irreconcilable," the

commission recommended that "the government should give the Bank an assurance that it accepts full responsibility for the proposed policy, and is in a position to take, and will take, any action necessary to implement it. It is then the duty of the Bank to accept this assurance and to carry out the policy of the government."

In other words, the royal commissioners believed that, in the final analysis, the central bank should defer to the government. The same view was taken in 1945, when the Commonwealth Bank Act was redrafted. The new legislation also required the bank to consult regularly with the government and with Treasury on policy matters. The Banking Act passed in the same year gave final responsibility for setting interest rates and the exchange rate to the government, while allocating to the central bank responsibility for the special accounts system (later the statutory reserve deposit ratio) and advising the banks on lending policy.

The Commonwealth Bank Act was amended again in 1951 to allow for a more complicated system to be followed in the event of a policy disagreement between the bank and the government. The same arrangement was included in the 1959 Reserve Bank Act and remains in the current legislation. Again, it was expected that disagreements would be settled through discussion and mutual agreement, but if that proved impossible, the dispute would be decided by the governor-general acting on the advice of the executive council — by the government, that is. In other words, the government would win the day in any disagreement with the bank, but the decision had to be tabled in both houses of parliament, and the government had to state publicly that it — and not the bank — was responsible for the policy.

In 1981, the Campbell inquiry into the financial system dismissed the idea that the Reserve Bank should be given "absolute statutory independence," arguing that

> proposals to make the Bank fully independent of government would, in the committee's view, amount to the substitution of bureaucratic for political discretion which would be inconsistent with the processes of democratic government. Quite apart from constitutional limitations, it would be thoroughly undesirable for the Bank to hold to a monetary policy which did not have the support of the government and the parliament.

In short, the committee held that "ultimate determination of and responsibility for overall economic policy — including monetary policy — cannot be effectively divorced from government and parliament." It was "important that the monetary authorities be effectively accountable to the public and the parliament," and this required "a clear identification of responsibility." It was also "desirable that the community be kept well informed of the objectives underlying the Bank's monetary policy and any constraints on the implementation of that policy."

While there have been several occasions since the early 1950s when disagreements between the government and the bank took the parties to the brink of invoking the disputes settlement clause of the Commonwealth Bank/Reserve Bank Act, in each case one of the parties backed off, or a mutually agreeable resolution was ultimately found. Most of the disagreements occurred during the time of the Fraser government and usually involved a reluctance by the monetary policy committee of cabinet —

dominated by ministers from rural electorates — to agree to the bank's desire to tighten monetary policy. Treasurers and Reserve Bank governors were usually agreeable to compromises, with governors upholding the view that governments should have — and in any event, would have — the final say. On some occasions the government backed off, fearing the bad publicity associated with a public brawl with the central bank.

Bernie Fraser, in his very first speech as Reserve Bank governor in late 1989, acknowledged that:

> Many views have been expressed on central bank independence over the years. Some people would like to see more powerful and more independent central banks. Some would like to abolish central banks altogether. Others again see a need for central banks, but seek to limit their discretionary use of power (and hence their independence) by prescribing targets or rules to govern their behaviour. There are no clear dividing lines in this debate.

That said, he thought that "few would argue… that central banks should pursue monetary policies to the point of disregarding other government policies and priorities. In another speech on central bank independence, given in 1994, Fraser declared that if "central banks are to be independent of the government, then they must be accountable for their actions. Not only is this proper in a well-run society, but public accountability can help to preserve the independence of central banks." And he thought that "provided the decisions of central banks are competent to begin with, and are transparent and understood by the public, there will be less opportunity for political interference."

As for the view taken by treasurers about central bank independence, Paul Keating expressed his position in no uncertain terms — as one would expect. In an address in Sydney in 1990, he said he would not "abrogate responsibility for the stance of monetary policy from the elected government to unelected and unresponsive public officials," adding that the "notion that appointed officials can do what elected governments cannot do is nothing more than gibberish." He affirmed that he was "a believer in democratic institutions" and was "prepared to wear responsibility for the policy settings." On one occasion he said that he had the Reserve Bank in his pocket, and on another occasion he claimed that the Reserve Bank did what he told it.

When he became treasurer, Peter Costello took a quite different view. He was determined to waive his right to approve changes in the bank's policy rate — the cash rate. In return for this independence, he expected the bank to submit itself to the scrutiny of parliament by appearing before appropriate parliamentary committees and explaining its actions to the public in published reports and speeches by senior bank officers. These concessions and requirements have been set out in successive statements on the conduct of monetary policy released and signed jointly by treasurers and Reserve Bank governors.

Since the mid 1990s, when the first Statement on the Conduct of Monetary Policy was issued, the Reserve Bank's public communications have increased enormously. Governors and other senior officers frequently make speeches that seek to explain the bank's thoughts and actions; the bank produces a monthly *Bulletin,* which includes research papers and other explanatory material; it also publishes separate research reports and volumes of conference papers, and presents papers at workshops; the bank

issues public notifications of changes in the cash rate and publishes minutes of board meetings; and senior bank officers appear regularly before parliamentary committees. In one of his last speeches as governor, Fraser could rightly say that the bank has "worked hard to explain clearly to the public, the parliament and the markets where it has been coming from, and what it has done, and why. I think the Bank has come a long way in this regard, and much further than most other central banks."

Long before these developments, in 1945, the Australian parliament approved a charter for the central banking activities of the Commonwealth Bank, setting out what it expected the bank to achieve. The same charter was assigned to the new Reserve Bank in 1959. Perhaps more than any other central bank — and certainly more than most central banks — the Reserve Bank of Australia appears to be conforming with what Paul Tucker proposes for institutions possessing "unelected power." •

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