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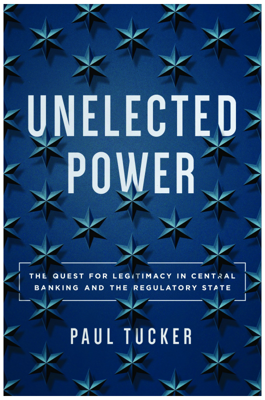

Unelected Power: The Quest for Legitimacy in Central Banking and the Regulatory State

Lawrence Goodman Interviews

Paul Tucker[1]

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The Center for Financial Stability (CFS) thanks Paul Tucker for ***Unelected Power: The Quest for Legitimacy in Central Banking and the Regulatory State***. ***Unelected Power*** is extraordinary from many perspectives. It is broad and deep. It stretches from the role of government agencies to central banking now and into the future. The book is extremely well researched. It is a joy to read. The footnotes and quotes are worth the price of admission alone.

We are grateful to Paul Tucker for sitting down with Lawrence Goodman and CFS friends. The following are excerpts from a subsequent conversation.

Q. Paul, why did you write "Unelected Power"?

I wanted to do two things, which turned out to be related. One was to explain why I, and others among the Bank of England's then leaders, leaned against some of the regulatory powers people wanted to us to have after the Great Financial Crisis (GFC), 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.

But the other thing driving me was a wish 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, and activist judges --- taking us toward a form of undemocratic liberalism. The book 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. That theme of the book turned out to be especially important for the US, where too many people in the center ground of politics, many technocrats among them, seem to have lost faith in Congress. To be honest, I have been a bit alarmed by that. Even if their dismay with Congress were warranted, relying more and more on unelected policymakers to fill the gap is not a sustainable answer in the long run.

[1] Sir Paul Tucker is a fellow at the Harvard Kennedy School and chair of the Systemic Risk Council. Previously, he was Deputy Governor at the Bank of England, sitting on its monetary policy, financial stability, and prudential policy committees. Internationally, he was a member of the G20 Financial Stability Board, leading its work on too big to fail; a director of the Bank for International Settlements, and chair of its Committee for Payment and Settlement Systems.

Q. Have central banks become a fourth branch of government?

In most advanced-economy democracies, no. In the US and elsewhere, the central bank is formally insulated from day-to-day politics but also subordinate to the three main branches. Congress could abolish Fed independence if it chose. The European Central Bank (ECB) has been challenged in the constitutional courts. Central bank leaders are nominated by elected executive branch politicians.

Central banks are a bit special, though, compared with much of the administrative state. Because the monetary levers are latently instruments of taxation, they cannot be given to the elected executive branch without violating the values of the separation of powers. Delegating to a constrained independent agency is, in effect, a solution to this problem, so long as the constraints and incentives are robust. In that case, monetary independence is a corollary of our high-level constitutionalist values, as I discuss in chapter 12 of Unelected Power. (That means, by the way, that central banks should not choose their own inflation target or, where they do, as in the US, they should engage in public debate before deciding.)

In the euro area, however, the central bank is much closer to being a fourth branch. At root, that is because the confederation of member states doesn't have a consistent constitutional structure: the euro area does not have a political fiscal authority but, in the ECB, it has created a body with quasi-fiscal powers. We saw what that means when, in 2012, the ECB rescued the euro-area and its wider European Project of ever closer union. No other European body could have provided that existential support. That wouldn't remotely be true of the US or my own country, Britain..

Q. How should democracy and the rule of law impact central banking?

Much the most important thing is to say that they should, of course. Here in the US I think that technocratic defenders of the Fed (and other regulatory bodies) would do well to take seriously the sincerity of, to use labels I employ in the book, the "Constitutionalist Right" and the "Participatory Left" when they express unease about the administrative state cast in terms of their political values.

This is the big subject of Part 2 of the book. Over simplifying, I argue that the purposes and objectives of central banks should be forged through democratic politics, and that they should be carefully overseen by Congress. When it comes to independent agencies intended to be insulated day to day from both elected branches, legislators would do better to focus on the high policy of framing monitorable objectives than on getting into the detail of specific regulatory measures. For example, in the field of financial stability policy, just how resilient do legislators want the core of the system to be?

Seen like that, oversight by judges of particular regulatory decisions cannot substitute for a well-crafted mandate. Nor can it fill the democratic deficit that results from vague, unranked objectives that leave unelected officials perforce making the really big choices on behalf of the people.

But the values associated with the rule of law obviously matter to. For example, they require that discretionary policy be as systematic as possible: that's to say consistent over time and across individual cases. The debate about whether the Federal Open Markets Committee should adopt a rule for monetary policy should be seen in that broad light. The values matter even if, as I happen to believe, no mechanical rule is to hand.

Q. The discussion of inside (private sector or broad) and outside (central bank) money is essential. As you know, CFS has developed a unique database and analytic capacity to measure monetary and financial liabilities. So, the distinction is important to us as well. You differentiate inside and outside money to develop the "Money – Credit Constitution." What is its policy relevance?

Much of the generation who dominated central banking in the decade or so before the GFC broke out in 2007 had little or no interest in banking, and didn't think of it as part of the monetary system. That was a big mistake. Most of the money we use as households and businesses is the deposit-money created by private banks (plus, I should add, the money-like liabilities of the so-called shadow banks, intermediaries that provide banking-like services but are not classified as banks as a matter of law and regulation). Unsurprisingly, when the banking system imploded, central bankers found themselves at the scene of the disaster as the Lender of Last Resort (LOLR), and also rediscovered that implementing regular monetary policy was much much harder in those conditions.

Quite a few years ago, the late James Buchanan argued that we needed a Money Constitution. In a world with fractional-reserve banking, and so with the money/payments system intertwined with the credit system, I argue that it should be a Money-Credit Constitution (MCC).

An economy's MCC would comprise, broadly, an objective for price stability; a standard of resilience for the private banking system, with consequent constraints on balance sheets; a lender-of-last-resort regime to provide liquidity insurance to sound intermediaries; a statutory framework for resolving fundamentally bust firms in a more or less orderly way, so that the LOLR doesn't bailout such firms but sticks to its job of providing liquidity reinsurance; and, crucially, constraints on the use of central banking's latent fiscal and regulatory powers.

This would be a world where, among other things, broad money is taken seriously, alongside a wide range of credit indicators.

Q. The story told about President Truman crossing the street to avoid then Fed Chair Martin speaks volumes. Today, for better or worse, balance sheets are intertwined. How should lines be drawn between fiscal and monetary activities?

The President felt betrayed after the long battle in the late 1940s/early 1950s to restore Fed independence after it had, rightly, acted as an instrument of government policy during WW2 and its aftermath to hold down long bond yields. The Truman administration wanted that to continue during the Korean war, but the money supply risked outstripping demand after the restoration of economic freedom.

But not all Treasury/ central bank cooperation is automatically inflationary. I would put it more strongly: so long as the central bank's mandate and powers are clearly and carefully delineated, cooperation between the monetary authority and the fiscal authority is possible and, in specific circumstances, can be desirable. For example, in Britain when the Bank of England embarked upon quantitative easing (QE) at the beginning of 2009 we first obtained a written, published agreement from government that they would not exploit what we were doing, and so undo some of its effects, by lengthening the maturity of their debt issuance in order to lock in the lower yields on long bonds. Views differ on whether Treasury did do that here, but certainly there was no agreement that they wouldn't do so. What's more, it is occasionally suggested that approaching Treasury to obtain such an agreement would have compromised the Fed's independence. I think that's muddled thinking.

But that is not to say that coordination in emergencies is easy. Compared with the response to the 1930s' crisis, when elected politicians led the policy response, this time round it has proved all too attractive for elected policymakers to sit on their hands in the knowledge that central banks would have no choice, given their statutory objectives, other than to reinvent themselves as the US Cavalry, intervening in credit markets to stimulate demand and steer the allocation of resources. This problematic strategic interaction is at the root of central banks having become the only game in town, as the saying goes. The central bankers can't do much about it other than being candid with the public that they can produce stability but not prosperity. Being open with the public will help to highlight the space vacated by politicians.

Q. The quotes and footnotes in "Unelected Power" are priceless. One of my favorites is "Time is getting short. We want to get this economy going." Ironically, this is Fed Chair Arthur Burns pressing President Richard Nixon rather than the other way around. What counter examples of central banking excellence exist for motivating future and current leaders?

Chairman Burns ended his career with a valedictory lecture entitled "The Anguish of Central Banking", as well he might. His most illustrious successor, Paul Volcker, demonstrated that it is possible to be an independent central banker who delivers something simple but vital for the economy and society they serve. In Europe, I think of Eddie George (Britain) and Jacques Larosiere (France and IMF), leaders who understood that a central banker needs to be able to navigate politics in order to stay out of politics. A clear, constraining mandate is a precondition for that. But self-restraint is vital too. As relative newcomers to the pinnacle of power, central bankers could usefully look to the history of the judiciary and of the military for examples.

Q. Can monetary policy ever be normalized?

Yes. And it is obviously important that it should be.

One challenge here is that central bankers today cannot remotely know what the demand for their money will be once economic recovery becomes entrenched and QE is no longer needed. But, in fact, they don't need to know. Rather than stipulating the level of central bank reserves that each bank must hold, they could let banks themselves choose. We operated a system like that in Britain for a few years before the crisis (in the jargon, "voluntary reserve averaging").

This is not just a techy thing. It would usefully reduce the number of policy instruments central bankers have to set during financial peacetime, without ruling out using QE in emergencies.

***Q.* Ten years after the crisis, what still needs to be done? What have we over done?**

The failure to produce a coherent, general policy regime for shadow banking is hard to justify, and may well end up being the Achilles Heel of the new dispensation for finance. Second, I cannot understand why policymakers have not urgently ensured that they have the powers and policies to resolve a failed clearing house --- infrastructure-providers that have been "Too Important to Fail" since the G20 Leaders (and, here in the US, Congress) mandated that most of the derivatives markets must go through them.

On the other side of the ledger, legislators in a number of jurisdictions, including the US and EU, overshot in applying requirements designed for big banks and dealers to much smaller community banks. To be clear, that did not come out of the international policy making bodies (Basel), but was a local choice. Now legislators are correcting their early regulatory exuberance, but at least here in the US look likely to soften things for the biggest firms too, which would be a mistake.

Q. What was surprising to you after having researched and written "Unelected Power"?

Starting outside the US, I was surprised that Germany is almost unique in having a constitution that expressly recognizes the administrative state but one that then holds that there shall be no independent agencies, which is neither realistic nor necessary, and I doubt that it is de facto true on the ground. I was half-surprised, given our deep tradition of parliamentary accountability, that Britain has become almost casual about who holds power: there has been much more debate in the UK about central bank powers than about other regulatory fields. By contrast, I was interested by how the French have tried to solve these problems in a practical but principled way.

Here in the US, I was powerfully struck by one big thing. Members of Congress have incentives to shed power without constraining the agencies of the administrative state via clear, monitorable objectives. In the language of economists, that is incentive-compatible. But it is not consistent with the deep political values that animated this country's founding and Constitution. In other words, it is not values-compatible. If I am right about that, it is a very big, slow motion problem, striking at the heart of the system of government. For American readers, I think that argument (built in Parts 2 and, especially, 3) is more important than anything I say about central banking.

Thank you for your time, Paul and writing "Unelected Power."

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