

# *UNELECTED POWER*

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***SOLVING THE DEMOCRATIC  
DEFICIT IN CENTRAL BANKS AND  
OTHER INDEPENDENT AGENCIES:  
FILLING A GAP IN  
CONSTITUTIONALISM***

# POWER OF THE POST-CRISIS CENTRAL BANKS

- Poster boys and girls of today's Unelected Power
  - New third pillar alongside Judiciary and Military
- Used *balance-sheet powers* like never before
  - QE, steering supply of credit, LOLR, and Market maker of last resort
- **Latent quasi-fiscal powers o/a capability to impose inflation tax**
- And new regulatory powers
  - Part of *regulatory state* as well as *fiscal state*
  - So standard defense of independence insufficient

# BASIC PROBLEM AND THESIS

- Too much government power lies in unelected hands
  - Marginal US lawmaker an unelected regulator or judge
- Government no longer designed in a principled way
  - **gap in constitutionalism:** Locke, Montesquieu, Madison
- Need *Principles for Delegation*

# FOUR HIGH-LEVEL THEMES OF BOOK

- Legitimacy up there with Justice
- Technocracy v. Populism:
  - Technocracy should retreat a bit
  - Importance of rule of law and democracy in debates about Fed
- Legal liberalism is insufficient:
  - Judges guarding against the arbitrary exercise of power cannot cure a democratic deficit: our republican values matter too
- Our deep political values should constrain Rational-Choice Institutional Design:
  - **Political Values Robustness Test** of RC design precepts

# WHY LEGITIMACY MATTERS

- Legitimacy makes a system of government resilient in the face of inevitable policy failures and disasters.
- Representative democracy special partly because
  - It separates how we feel about the government of the day from how we feel about the *system of government*
  - Because we can sack (vote out) our governors
- Except we cannot vote out our unelected governors
- Liable, in slow motion, to erode trust in govt unless it is principled and widely understood

# CONSTITUTIONALISM

- Shapes structure of government
- Limits on government
- Veto points matter hugely:
  - USA: hard to pass laws; once passed, hard to change or repeal them
- Structures the incentives of those in the elected branches, and the judicial branch
  - UK: Parliament can legislate easily, so judges insist they decide points of law
  - US: Congress legislates with difficulty, which might explain why judges 'defer' to admin agencies on some questions of statutory interpretation (*Chevron*)

# ADMIN STATE AND CONSTITUTIONALISM

- Germany a rare exception among advanced-econ democracies:
  - Under German Basic Law, formally can be no IAs (other than BUBA post Maastricht). Not obviously true *de facto*
- France: Written constitution puts admin under PM, but IAs carved out by Const Court
  - IAs now structured under a generic statute, following critical Senate report
- UK: flexibility (of course)
  - Long resisted o/a doctrine-cum-tradition of parliamentary accountability
  - Partly solved through Select Committee system; now lots of IAs

# US DOCTRINE ON THE ADMIN STATE

- Not provided for explicitly by the Constitution
- Court has allowed
  - Admin state to exist, provided delegated regime has an “intelligible principle”
  - Congress to stipulate case-by-case that an agency’s policymakers can be sacked only “for cause”.
  - Agencies regarded as part of Exec Branch: when issue legally binding rules, merely filling in the details left by Congress

# VAGUE AND MULTIPLE OBJECTIVES

- FCC: in “the public convenience, interest, or necessity” and “so as to provide a fair, efficient, and equitable distribution [of radio services]”
- Federal Energy Regulatory Commission: to ensure that utility-type charges are “just and reasonable”
- EPA: to set a policy for air pollutants “requisite to protect the public health” with an “adequate margin of safety”, and with a secondary requirement to deliver policies “requisite to protect the public welfare”
- SEC: to deliver a combination of investor protection, fair, orderly and efficient markets, and capital formation
- Federal Reserve: safety and soundness of banking groups.

# INDEPENDENT AGENCIES: DEFINITION

- Definition: *Insulated from the day-to-day politics of both elected branches of government*
- Attributes of independence:
  - 1) Control over delegated policy instruments
  - 2) Job security of policymakers
  - 3) Budgetary autonomy (or at least not an *annual* budget process)

# CONFUSION IN USA

- SEC, CFTC, FTC, FCC not IAs on this definition: annual budget appropriation process gives Congress ongoing leverage
- CFPB is an IA on this definition (but does not satisfy the *Principles*)
- Fed and FDIC are IAs
- UK: FCA, OfCom, utility regulators are IAs

# DEGREES OF INSULATION MATTER

- Part of problem is lack of distinction between
  - *Exec Agencies* such as EPA: President has day-to-day leverage, giving some democratic cover
  - *Semi-independent agencies* such as SEC: sensitive to shifting currents of Congressional opinion due to annual budget process, and so can look to President for protection
  - IAs
- **Degree of insulation conferred is rarely principled, but result of balance of forces and incentives**

# INCENTIVES-VALUES (IN)COMPATIBILITY

- Current state of affairs might be *incentives-compatible*
- But it is NOT *values compatible*
- Hence need to generate a soft political norm, eg the *Principles*

# JUSTIFICATIONS FOR DELEGATION-WITH-INSULATION

- *Fair adjudication only*: but cannot validate rule-issuing power
- *Expertise*
  - Landis during 1940s
  - Does not work: could have an independent body that gives public advice to a political decision maker
  - Necessary but not sufficient

# CREDIBLE COMMITMENT

- To work, some policies require trust in government promises
- Technocrat v. Politician incentives
  - Alesina and Tabellini
  - *Politician*: re-election/current popularity:
    - pursue welfare *today*
  - *Technocrat*: professional and public reputation for doing job
    - Deliver statutory mandate
    - Requires mandate that constrains
    - ***And a society capable of bestowing esteem: echoes old republican idea of honour***

# *ROBUSTNESS TEST: OUR* POLITICAL VALUES

- But most of govt faces problems of credible commitment
- Need to bring in our political values
  - 1) Democracy
    - participation
    - representation
    - policy via trial and error
  - 2) Rule of law
    - Generality, predictability, transparency
    - Fair adjudication and due process
  - 3) Constitutionalism
    - Separation of powers

# NON-MONOLITHIC VALUES

- Goes beyond legal liberalism, as in:
  - Legally valid delegation by legally elected assembly
  - Compliance with administrative law policed by judges
- Our *republican values* matter too!
  - Why the technocratic retreat is needed
- Burke's prescriptive legitimacy: entrenchment via the test of time
- Technically, book conducts a *robustness test* rather than seeking an overlapping (lowest common denominator) consensus
- Effect is to pile up the requirements place on IA-regime design

# *PRINCIPLES FOR DELEGATION TO IAs*

- 1) Delegation Criteria for *whether* to delegate
- 2) Design Precepts for *how* to delegate
- 3) Multiple-Mission Constraints

# WELFARE v LEGITIMACY

	<i>Satisfy Principles</i>	<i>Could satisfy Principles</i>	<i>Cannot satisfy Principles</i>
Delegated to an IA	Democratically legitimate welfare enhancement	Remediable legitimacy problem	Unremediable legitimacy problem
Under political control	N/A	Welfare opportunity cost	Sensible.

# DELEGATION CRITERIA: *WHETHER*

- 1) Broadly settled public preferences re purpose
  - Environment policy v. financial stability
- 2) Problem of credible commitment
- 3) No big choices re distributional issues or high level values
  - Tax and social security

# DESIGN PRECEPTS: *HOW* (1)

- ✓ Legislature to set a **clear objective that can be monitored**,
  - *set after public debate*
  - specific objective constrains the ability of politicians to shape policy through power of appointment: '*personnel is NOT policy*' for well-designed IAs
- ✓ **A revived non-delegation doctrine for IAs only**
  - So IA doesn't have to make long term trade offs, decide what its mission requires it to achieve
- ✓ Would need a political norm that the Court felt bound to respect
  - Court's legitimacy at stake here too

# DESIGN PRINCIPLES (2)

- ✓ Decisions via one person-one vote, *after deliberation*
  - Disperses power; aids public debate by revealing disagreement; internal policing of policymakers substituting their favored goals for the legislature's
- ✓ Powers not to be used in ways that interfere unduly with liberal freedoms
  - German principle of proportionality

# DESIGN PRECEPTS (3)

- ✓ IA to publish *Operating Principles* for how will aim to exercise discretion in systematic and fair way
  - Contrast pre-crisis LOLR policy
- ✓ Transparency sufficient to underpin accountability to elected assembly
  - Whose key role is decide whether to maintain, amend or repeal regime

# JUDICIAL REVIEW OF IAs

	<i>Principles-compliant</i>	<i>Principles-deficit</i>
No 'basic rights' at stake	Thin review: Eg, not unreasonable	Less thin review: Eg, clearly reasonable
'Basic rights' at stake	Thicker review: Eg, proportionality	Thick review: Eg, proportionality and merits

# EMERGENCIES

- Clarify *ex ante* what happens when an IA could help contain a disaster but is at boundary of powers:
  - eg temporary formal extension of powers granted by elected politicians
  - principle is resisted by US Hamiltonians: big challenge for Fed
- If IA could act within powers but in ways not remotely contemplated by public or legislators, consult elected politicians
  - eg ECB should have done so

# MULTIPLE-MISSION CONSTRAINTS

- 1) Missions intimately intertwined
- 2) Better results expected from joint production
- 3) Separate statutory policy committees for each mission, with a majority of members of each committee on only that committee
  - To mitigate incentive to prioritise most salient: Wilson; Holmstrom/Milgrom
  - eg Greenspan Fed
- 4) Chair and other members on multiple policy committees charged with ensuring smooth info flows and joined-upness

# EXAMPLE 1: ANTI-TRUST

- Highly vague statutory objectives
- Judges decided to switch from Harvard School to Chicago School doctrine
- High policy not set by elected representatives
- Violates *Design Precept 1*
- Contrary to our deep values

# EXAMPLE 2: PRUDENTIAL SUPERVISION

- IMF and BCBS Core Principles insist on independence
  - Supervisors insisted cannot publish state of firm
  - Hence accountability via oversight impossible until after failure
  - And typically highly vague or multiple statutory objectives
- 
- A “trust us” regime
  - Not consistent with our political values

# EXAMPLE 3: INCIPIENT CRISIS IN SECS REG?

- SEC is responsible for: protecting investors; maintaining fair, orderly and efficient markets; and facilitating capital formation
  - Trump Administration has appointed a chair who plans to shift the emphasis to the last, in hope of reinvigorating the economy.
- UK's Financial Conduct Authority has a strategic objective of ensuring that financial markets function well, and three operational objectives:
  - securing an appropriate degree of protection for consumers
  - protecting and enhancing the integrity of the UK financial system
  - promoting effective competition in the interests of consumers.
- No standard is set and no weighting is given for trading off the operational objectives.

# WHAT ABOUT THEIR ROLE IN STABILITY?

- If monetary authorities are independent so as to help solve society's problem of making credible commitments to maintain stability...
- And if, at least in the wake of the financial crisis, securities regulators are integral to maintaining financial stability....
- Then securities regulators need, in their stability role, the same degree of independence as monetary authorities and to be subject to the same kind of constraints.

# *OVERMIGHTY CITIZENS?*

***THE QUEST FOR LEGITIMACY  
IN CENTRAL BANKING***

# MONETARY INDEPENDENCE: CURRENT CRITIQUE

*“Central bank independence had a specific justification. Monetary policy was thought to have major dynamic consistency issues and did not have much non-technical political content. In today’s world where the dominant problem is too little not too much inflation the dynamic consistency argument loses its force. And the greater salience of exchange rate issues, fiscal monetary cooperation and credit allocation aspects of monetary policy draws it closer to policy normally delegated to democratic institutions. So at a minimum central bank independence needs reconsideration and it’s possible that it can no longer be justified in its current form.”*

Larry Summers, exchange with the author, 2017

# CBI: THE DEFENCE

- Commitment problem wider than strict time-inconsistency leading to an inflation bias
- Political monetary policy makers would have found it hard to provide the post-2008 stimulus needed to support economic recovery:
  - unpopular with some high-propensity-to-vote citizens: savers
  - If they had tried, would not have been trusted to refrain from inflating away the debt
- Plus a constitutionalist argument

# CONSTITUTIONAL CENTRAL BANKING

- Under fiat money, independence for the monetary authority is a corollary of the higher-level separation of powers between the fiscal authority of the legislature and the elected executive government
  - Other options are a committee of Congress or a commodity standard
  - Doubt whether the volatility in output and jobs entailed by gold standard would be tolerated under *full-franchise* democracy
- Central banks a solution to the problem of not giving the monetary levers to the elected exec
  - Puts the burden on design and constraints

# POLITICAL SCIENCE EXPLANATION OF CBI

- Standard story:
  - Legislators serve interest groups, and conservatives serve finance
  - Finance dislikes inflation
  - Therefore, CBI will be granted by Right so as to lock in low inflation policy
- So why did Labour give BofE independence? Alternative story:
  - Right will not grant CBI when it thinks Left will be worse at monopol, helping bring Right back into power
  - So Left has incentive to grant CBI Eg Italian Communist Party position
- Sustained only if general benefits: saves inflation-risk premium

# WHAT MORE?

## POSITIVE ECON V. POLITICAL ECONOMY

- Debates conducted as though purely challenges in positive economics: which instruments work best: *market failures*
- But what about *government failures and political values*?!
- Little said about design of policy institutions
- Implicit assumption in macro-finance: if central banks are most capable policy body, they should be empowered with previously missing instruments

# FRACTIONAL RESERVE BANKING

- Our societies permit FRB
- Political economy: a device for separating government from the allocation of credit
- Banks are providers of liquidity insurance
  - through demand deposits and committed lines of credit
  - enables households and business to economize on holdings of liquid assets
- But leaves banks (and near banks) fragile:
  - liabilities highly liquid, but assets that are opaque and illiquid
  - Hence risks of runs: Diamond & Dybvig

# THE LIQUIDITY REINSURER

- Enter central bank as liquidity reinsurer: Lender of Last Resort (LOLR)
- My paraphrase of Walter Bagehot's famous dictum:  
*Central banks should make clear that they stand ready to lend early and freely (ie without limit), to sound firms, against good collateral, and at rates higher than those prevailing in normal market conditions.*
- This version emphasizes lending to *sound firms only*.
- *Principles for Delegation* require function should be formalized, with objective, constraints etc

# TOWARDS FINANCIAL STABILITY

*“I insist that neither monetary policy nor the financial system will be well served if a central bank loses interest in, or influence over, the financial system.”*

Paul Volcker, “The Triumph of Central Banking?”, 1990

# ONE FUNCTION LEADS TO ANOTHER

- LOLR invariably at the scene of financial crises and disaster
- Needs information to judge soundness of potential borrowers
  - in circumstances where prophylactic sup and reg have “failed”
- Will want to be able to influence policy on minimum resilience requirements, and to be assured supervision is professional
- BofJ and BUBA do this *de facto* but not *de jure*
  - not in accord with today’s application of political values: accountability

# *MONETARY SYSTEM STABILITY*

Mission with two parts:

- Stability of the value of central bank money in terms of goods and services
- Stability of the value of private banking-system money in terms of central bank money

# A DELEGATED STABILITY-POLICY REGIME

- Managing credit cycle: no monitorable objective proposed
- Instead, frame ‘finstab’ objective in terms of *resilience of system*
  - Maintenance of core services through stressed conditions
  - Politics shd decide/bless targetted degree of resilience given any long-run trade-offs
- Micro-prudential objective “safety and soundness” to be recast/interpreted in that light
- Dynamic macropru policy directed to maintaining desired degree of resilience

# MISSING REGIMES

- Not same as
  - ✓ mitigating every resource misallocation caused by fin system pathologies
  - ✓ leaning against real economy over-indebtedness that does *not* threaten system resilience/stability, but might be a drag on economic activity
- Those powers could be granted to elected exec branch
  - Central bank might in principle give public advice
  - But that too would need a carefully designed statutory framework

# *A MONEY-CREDIT CONSTITUTION*

- Buchanan argued for a Money Constitution
- Given FRB, must be a *Money-Credit Constitution*. Five broad elements:
  - 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.

# LIBERAL CONSTRAINT BITES ON MACROPRU

“An IA’s rule-making should not interfere with individual’s liberal rights more than necessary to achieve the legislated purpose and objective (proportionality)”

- Problem for, eg, across-the-board LTV and LTI caps for borrowers: not proportional because other, less invasive options

# BALANCE-SHEET POLICY

- Time consistent: central banks should not deny that they will do things that in fact they would do. So any absolute constraints must be in primary legislation and incentive-compatible for law-makers.
- Balance-sheet operations should at all times be as parsimonious as possible consistent with achieving their objectives, in order to aid comprehensibility and accountability.
- Minimize risk of loss consistent with achieving statutory objectives.
- *If* permitted to operate in private-sector paper, should be in as many sectors as possible; with selection of individual instruments as formulaic as possible; and valuation methodology published.

# BALANCE-SHEET SIZE

- Following paying interest on reserves, could in principle have three instruments:
  - policy rate (and talk about reaction function)
  - size of balance sheet
  - composition of asset portfolio.
- Principle of parsimony means not all are needed all of the time
- Under normal circumstances, let balance sheet sized be determined by banks choosing the level of reserves they each wish to target over a monetary maintenance period

# THREE PILLARS OF UNELECTED POWER

*“I don’t hate [him]...I do love him, but the day that I say that I agree with him when I don’t, is the day he must get rid of me because I am no use to him anymore.”*

Field Marshal Alan Brooke after a row with Winston Churchill, Spring 1944

*“The Justices have their being near the political marketplace, in which the effects of their judgments are felt...A number of controls are built into their craft, which they practice under the scrutiny of a profession whose expectations and approval must matter to them.”*

Alexander Bickel, 1962

*“Central bank governors require three qualities above all. A deep commitment to price stability. An ability to be clear and direct to politicians about the policies that are required to produce economic stability. And the ability to be unpopular when circumstances require.”*

Mervyn King at a retirement dinner for Jean-Claude Trichet, 2011

# SELF-RESTRAINING CENTRAL BANKERS

- Like the military but unlike the judiciary, the central bankers must be ready to advise in private on the wider government policies that are *necessary* for monetary-system stability
- Unlike the military, precisely because they have job security, they must not press and press, while not equivocating in their advice
- Unlike the military, they can repeat this advice in public at their own initiative, but in doing so the intimate connection with their formal mandate must be explicit and able to withstand tough scrutiny;
- They cannot be in the business of offering their opinion, in private or public, on things they happen to know about or are interested in but do not rely upon in fulfilling the trust placed in them by legislators;
- Like the judiciary, they must not be drawn into offering specific private advice or public remarks about things they will or might have to decide
- Like the judiciary, as legitimacy seekers, they can (and, rationally, ought to) explain their institution to the public
- Like the judiciary, they must be ready to take criticism.

# *UNELECTED DEMOCRATS*

THANK YOU FOR LISTENING,  
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