A GAP IN CONSTITUTIONALISM: INDEPENDENT CENTRAL BANKS AND THE ECB

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POLITICAL SCIENCE EXPLANATION OF CBI

• Standard story:
  o Legislators serve interest groups, and conservatives serve finance
  o Finance dislikes inflation
  o Therefore, CBI will be granted by Right so as to lock in low inflation policy

• So why did Labour give BofE independence? Alternative story:  
  o Right will not grant CBI when it thinks Left will be worse at monpol, helping bring Right back into power  
  o So Left has incentive to grant CBI  

• Sustained only if shared benefits: saves inflation-risk premium
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
  o Other options are a committee of Congress or a commodity standard
  o 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
  o Puts the burden on design and constraints
STANDARD T-I ARGUMENT FOR CBI:
INCOMPLETE ON ITS OWN TERMS

• Rules (Kydland/Prescott):
  o But why would ‘they’ stick to the declared rule?

• Conservative central bankers who hate inflation (Rogoff):
  o But why would govt (re)appoint such a person, and what if they are only pretending to be conservative?

• Contract allowing govt to punish CB for missing target (Walsh):
  o But what if missing the target suits the govt?

• Infinite regress problem?
STANDARD ARGUMENT TOO NARROW: IGNORES POWER

• Balance-sheet powers used like never before
• Reflects inherent capability to alter consolidated state b/sheet:
  o buying govt debt changes maturity structure of state liabilities
  o buying private securities also expands state b/sheet and risks
  o profits/losses flow to govts (ie taxpayers)
• Plus, new regulatory and supervisory powers (Fed, ECB, BofE)
  o constrains banking in general
  o right of individual firms to trade
NEW THIRD PILLAR OF UNELECTED POWER

• Poster boys and girls of today’s Unelected Power
  o New third pillar alongside Judiciary and Military
• Latent *fiscal powers*: to inflate away debt
• *Law-making* regulatory powers
• *Adjudicatory* powers over individual banks
WHY LEGITIMACY MATTERS

• Legitimacy makes a system of government resilient in the face of inevitable policy failures and disasters. *OUTPUTS CANNOT SUFFICE*

• Representative democracy special partly because
  o It separates how we feel about the government of the day from how we feel about the *system of government*
  o Because we can sack (vote out) our governors

• Except we cannot vote out our unelected governors

• Liable, slowly, to erode trust in govt unless principled and widely understood
INDEPENDENT AGENCIES: DEFINITION

• Definition: *Insulated from the day-to-day politics of both elected branches of government*

• Attributes of independence:
  • Control over delegated policy instruments
  • Job security of policymakers
  • Budgetary autonomy (or at least not an *annual* budget process)
ADMIN STATE AND CONSTITUTIONs

France: written constitution puts admin under PM,
- but a space for IAs was carved out by Const Court
- now structured under a generic statute, following Senate report

UK: flexibility (of course)
- long resisted o/a doctrine of parliamentary accountability
- partly solved through Select Committee system: now lots of IAs

USA: Empty *non-delegation doctrine*
- sprawling variety of structures
ADMIN STATE AND CONSTITUTIONs (2)

• **DE:**
  - Unusually, explicit provision in BL for admin state
  - *But all parts expressly under ongoing ministerial control, as part of a chain of legitimation*
  - Very important for ECB SSM debate

• **EU**
  - Requires member states to have IAs in some fields
  - Eg, some utility regulation, and parts of banking supervision
JUSTIFICATIONS FOR DELEGATION-WITH-INSULATION

**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**
- *Politician*: re-election/current popularity: pursue welfare *today*
- *Technocrat*: professional and public reputation for delivering mandate
  - Requires mandate that constrains, and
  - To generate audience costs, *a society capable of bestowing esteem* (*republican honour*)
COMMITMENT v. DEMOCRACY

• But do embedded commitment devices violate our democratic political values?
  o Our *freedom to change our minds about ends and means*

• On the one hand, delegation is designed to help the democratic state deliver better results by sticking to the people’s purposes: in that sense credible commitment is enabling of democratically generated purposes.

• On the other hand, the people have to remain free to change their purposes.

• The resolution has to be either that there are some commitment problems where democracy, as ordinarily understood, should be suspended or, alternatively, that *institutional technology designed to enable credible commitment might come in degrees.*
COMMITMENT FOR REGULAR POLICY

• Question here is not whether, as a matter of law, independent agencies are Constitutional in any particular jurisdiction.

• But **whether the values of constitutional democracy are violated if one generation of elected legislators seeks to raise the costs of their successors (or, indeed, their future selves) departing from their preferred policy.**

• On the one hand, for some people the warrant of democracy lies in its capacity to produce better outcomes for public welfare.

• On the other hand, the very structure of representative democracy has inscribed into it a risk that elected politicians *deliberately* deliver poorer results than they had promised when standing for election.
IAs AS RULE-WRITERS

• Credible commitment problem can infect the legislative process itself

• Take a case of a major regulatory overhaul following a financial crisis. Because it will take some years, legislators worry about whether their resolve, and that of their backers, will hold as memories of crisis fade and the short-term allure of easy credit and asset-price inflation reasserts itself.

• Conscious of that risk, the legislators decide to bind themselves to the mast by delegating to an independent agency the job of filling in the detail of the reformed regime.

• Legislators trying to commit to their own high policy. They have not tightly bound their successors (or their future selves), because they cannot. But they have made any future backtracking more visible --- to commentators, the public, etc.
PRINCIPLES FOR DELEGATION
CONSTRAINTS ON IA REGIMES: OUR POLITICAL VALUES

**Freedom:**
- *republican* freedom from domination
- *liberal* freedom from interference exceeding what’s needed to deliver public purposes

Values of the *rule of law:*
- predictability, generality, clarity, etc
- fair and open adjudication

**Democratic** values:
- participation, representation, public deliberation, transparency, contestability, etc

**Constitutionalism:**
- separation of powers, etc
PRINCIPLES FOR DELEGATION TO IAs

1) Broadly settled public preferences re purpose
2) Problem of credible commitment
3) **No big choices** re distributional issues or high-level values
4) Legislature to set a clear objective that can be monitored
5) Decisions via one person-one vote committees, after deliberation
6) **Transparency enabling public debate and accountability**
7) Clarity re powers in emergencies
8) Multiple-mission agencies: separate committees with ‘dedicated’ majority
CONSTITUTIONALIST OPTIONS FOR IA-REGIMES

• *Principles for Delegation* proposed as a constitutionalist norm
  o either codified or an informal convention (in the space between politics and law)
  o ie, formalist constraints on IA regimes in general
• For specific regimes, a range of constitutionalist options
  o merely specify that an institution may or must exist (eg currency-issuer)
  o add any or all of objectives, powers, constraints

• More codified, less room for welfarist learning, and for democracy
• More entrenched, tighter constraints needed
SOME CONSEQUENCES
## JUDICIAL REVIEW OF IAs

<table>
<thead>
<tr>
<th>No ‘basic rights’ at stake</th>
<th>Principles-compliant</th>
<th>Principles-deficit</th>
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<tr>
<td>Thin review: Eg, not unreasonable</td>
<td>Less thin review: Eg, clearly reasonable</td>
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| ‘Basic rights’ at stake | Thicker review: Eg, proportionality | Thick review: Eg, proportionality and merits |
CENTRAL BANKS AND SUPERVISION
CENTRAL BANK AS LENDER OF LAST RESORT

• My paraphrase of 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.

• Means central bank always at scene of financial disasters
“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.”

ONE FUNCTION LEADS TO ANOTHER

• LOLR needs information to judge soundness of potential borrowers
  o 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*
  o not in accord with today’s application of political values: accountability in the public sphere
  o *Principles require function be formalized, with objective, constraints etc.*
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
MULTIPLE-MISSION CONSTRAINTS

1) Missions are intimately intertwined
2) Better results expected from joint production
   - eg, o/a info flows
3) Each mission meets tests for IA status
   - do not delegate a non-independent mission to a IA
4) Separate statutory policy committees for each mission
   - with a majority of members of each committee on only that committee
EMERGENCIES

• Clarify *ex ante* what happens when an IA could help contain a disaster but is at boundary of powers:
  o eg temporary formal extension of powers granted by elected politicians
  o in practice, probably relies on a delegated power to exec branch

• If IA could act within existing powers but in ways not remotely contemplated by public or legislators, consult elected politicians
  o eg ECB should have done so
THE ECB AND SSM
“Simultaneously more and, perhaps, less than a regular central bank” (p.393)

“The true power of the state (sovereignty) lies with whoever wields the power to act in emergencies. If, then, in an emergency the elected executive steps aside, leaving an independent agency, say...the ECB, to act alone, they are revealed as the true sovereign” (pp.243-4)

“Monetary technocrats adrift in the constitutional order of things, precariously perched as existential guarantors. Hence the legal and political dilemmas posed by the ECB’s Sisyphus-like labours to preserve Europe’s monetary union and the wider Project it represents.” (p.563)
NOT A REGULAR CENTRAL BANK

• ECB’s existence is much more deeply entrenched than regular central bank
  ➢ narrower constraints, normatively
• ECB has no counterpart EA fiscal authority but has same latent quasi-fiscal capabilities as any central bank
  ➢ de facto, EA’s existential guarantor (Schmittian economic sovereign)
• Deep tension. Compounds wider OGIT problem
ECB IN EMERGENCIES

• ECB should publish its contingency plans for extreme events.
• The political branches (Council and Parliament) should edge towards greater codification of the ECB’s crisis repertoire.
SINGLE SUPERVISORY MECHANISM

• As the LOLR, the ECB needs some role in regulation and supervision of EA banking system
• SSM is one decent way of delivering that. Good that:
  o formalized
  o distinct from Governing Council
SSM REFORMS

• Pity that national reps are in majority: reintroduces quotidian politics via back door
  o EBA same
• No member of ECB should also be a member of industry-sponsored or funded bodies

• Should articulate a monitorable objective
UNELECTED DEMOCRATS

THANK YOU FOR LISTENING,

PAUL TUCKER, ECB WATCHERS, FRANKFURT, 27 March 2019
ADDITIONAL SLIDES
“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
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
  o Central bank might in principle give public advice
  o 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:
  o an objective for price stability;
  o a standard of resilience for the private banking system, with consequent constraints on balance sheets;
  o a lender-of-last-resort regime to provide liquidity insurance to sound intermediaries;
  o 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;
  o 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:
  o policy rate (and talk about reaction function)
  o size of balance sheet
  o 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.