A coming crisis of legitimacy?

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1 An overview of the argument

In this article, I want to spell out why central banks may be heading for a crisis of political and democratic legitimacy, and to suggest a solution. I will set out the argument initially at a high level, then dig down into selected aspects.

A crisis of legitimacy is not inevitable. But unless some crucial things change, it may be the most likely outcome of differences between the evolving tasks of central banks as central bankers perceive them compared with how their social partners see them.

The fundamental problem is the difficulty in describing how we would use far-reaching transactional and regulatory powers to maintain "financial stability". We cannot yet describe with any clarity how delegated powers of the state would be used efficiently and fairly to achieve an end that we can only, for now, describe in the negative – the absence of crises, or worse still the absence of "too much" instability.

Yet central bankers generally think it appropriate that they be given extra powers, most of a regulatory nature, for independent execution. Exactly which powers are sought is not really clear. Quite a long shopping list is offered. Exactly how these powers would be deployed, in what circumstances, with what limitations, is not able to be articulated clearly. Most notably, it is difficult to explain how this big new fuzzy goal relates to existing goals.

To a limited extent, some central banks have explicitly been given new powers for these imperfectly defined purposes. More commonly, central banks are showing a strong inclination to use powers that they already have, or could be argued to have, for new, imperfectly-defined purposes. It is this *reinterpretation* of the proper use of delegated state powers that threatens legitimacy.

And as it happens, the circumstances in which boundaries of society's tolerance for reinterpretation of mandates are being tested are not propitious for such testing.

- Central banking mandates have already been liberally reinterpreted alongside use of unconventional monetary policies, causing some political discomfort (for example in Europe, especially Germany, and the United States).
- Trust in politics and political institutions is falling, quite generally and almost everywhere.
- For various reasons, central banks may be transitioning from a world in which they have had plenty of income to a world in which they are income-constrained. They may find themselves having to negotiate compensation from governments to cover fiscal agency and other services.

Let me quickly add that I do not think central bankers are necessarily wrong to believe that they have an obligation to society to make financial stability a key focal point of their work. There is a strong case to be made that central banks exist for more than price stability in a fiat currency world. Since their inception, in different and evolving ways central banks have been part of the hunt for stable and efficient monetary technologies that facilitate economic exchange across distance, between strangers and through time (that they have also been at times convenient channels for war finance is incidental). In this conception of the public

* The views contained in this article are personal, and should not be attributed to either the BIS or the CBGG.

good that central banks exist to supply, the reliability of the *system* of financial intermediation is just as important as the predictability of the exchange value of the monetary tokens that this system creates and exchanges.

But that is not the discussion that central banks had with legislatures, with society, when autonomy – distance from daily political command – was granted (or renewed) through the last third of the 20th century. For the most part, the discussion that led to autonomy was around inflation, or more generally around the nominal component of macroeconomic stability.[1]

What is holding back an expanded discussion about repurposing the use of state powers? Central banks are just not yet ready to have it, at least with the depth needed. Their level of knowledge is insufficient to answer the essential questions that would need to be asked:

- What exactly do you mean by financial stability (and don't just tell me the absence of instability)?
- Which part of changing financial conditions is bad, and which part good? Can you reliably tell them apart?
- How much stability – as you define it – do you think is efficient?
- What are the costs, the side effects, of using these powers that you seek? Who will bear those costs? Can you assure us that it is the same people who benefit from the gain in stability – as you define it?

Without being offered good answers to these questions, the issue for legislatures would be whether to delegate important state powers to agencies at arms length from the electoral process, without being able to delimit their use solely for agreed and stated purposes. Moreover, to agencies that already have major delegations. That is a big ask, and one rightly to be wary about.

This places central banks on the sharp horns of a dilemma:

- Logic says that financial stability is indeed part of the same public good that price stability aims to supply.
- Plenty of historical evidence says that severe interruptions to the workings of the system of financial intermediation involve serious real costs, much larger indeed than the real costs of moderate price instability.
- Instinct says that we can use regulatory powers to moderate the risks of such disruptions occurring (even if we don't yet know their full causes), and make the system more resilient to such dislocations, without imposing overwhelming costs or distortions.[2]
- And the basic logic of the public good that is a reliable monetary system says that such regulatory powers should be deployed *jointly* with other state powers aiming to deliver monetary stability. Or at least be considered in an integrated fashion.
- Together, all these things say that waiting until formal mandates can be properly spelled out is a counsel of perfection, and perfection can be the enemy of the good. Waiting would condemn our economies to unnecessary future crises. Existing powers *could* be used for wider purposes, and perhaps *should* be, especially in view of the logic that a central bank exists to deliver monetary stability in a broad sense.
- And in any case we know that central banks are likely to be held to account, in the court of public opinion, should they not have acted to prevent the next big financial crisis.

1 Conti-Brown (2016) makes this point strongly in his review of the concept of independence for the Federal Reserve. In his view, the concept is not only slippery (partly as it is not explicitly a product of the Fed's law), it is really attached most clearly to the task of keeping inflation down and not of getting inflation up, or to a multitude of other Fed tasks.

2 Cost-benefit analyses of the use of regulatory instruments is not something that financial regulators are much practiced at, at least by comparison with other regulators. Regulatory impact assessments and open-forum consultation process are much less frequent in the domain of financial regulation than the regulation of other economic activities, for example.

So what to do? How to resolve this dilemma? The only clear answers, it seems to me are: **First**, urgently invest more in filling the knowledge gaps. We need quickly to acquire the capacity to spell out: the nature of financial instabilty problem; the origins of the problem in terms of market and existing regulatory failures; and the public policy tools that might address the problem (including their strengths and weaknesses and their interaction with existing policies). **Second**, develop ways of setting financial stability objectives in law that properly recognise the multiple dimensions that are relevant for such objectives, and that allow for the adaptation of such objectives as the state of knowledge improves. Without improvements on both these fronts, I fear that a crisis of legitimacy is indeed likely.

I would now like to dig a little deeper into four aspects of these assertions, with the fourth aspect being an attempt to offer a way forward.

2 Monetary system stability as a public good

Consistent with the new-found relevance of financial stability to the central bank's task, Goodhart's (1988) argument that the essence of central banking is not the pursuit of price stability but the capacity to be a lender of last resort is now often cited approvingly.[3] There is a tendency to bypass the points that many early central banks were created as a part of an effort to fix problems in payment systems and provide monetary stability, and that the majority of central banks were created (in the 20th century) as a tool of government macroeconomic management.[4]

Giannini (2011) offers an additional perspective. He argues that both the lender of last resort and monetary stability perspectives are useful and relevant, yet both miss the point, which is that the functions of central banks are in evolution. The thing driving that evolution is mankind's millennia-old search for an effective and stable payment technology, a set of institutional arrangements that support monetary exchange and thus facilitate real exchange.

From this perspective, monetary stability and financial stability are two dimensions of the same public good, as opposed to two separate public goods. And that seems also to be the lesson of the many treatises on the history of money and of financial systems.[5] In these histories, both *money* and *credit* get strong billing. We may never resolve the question as to which is the chicken and which the egg, because both money and credit seem to have existed very early in the historical record, and both are about enabling economic exchange. Both are technologies that remove the shackles of the "simultaneous double coincidence of wants" of real time barter, allowing economic exchange to take place over time. Non-commodity monies in particular are trust-based technologies, equivalent in many respects to credit.

These histories also give top billing to the *mechanics of the financial system* – the service providers, the rules under which they work, and the resulting modalities of financial exchange and intermediation.

One can consider this same history through the new lens of a search for safe assets, to facilitate exchange and store value. Using this lens, we get very similar messages.[6] Commodity money has been unreliable because of episodic bouts of feast and famine. Transferable privately-issued credit instruments, such as bills of exchange and bank deposits have also had a patchy track record in acting as reliable safe assets but these, along with tradeable government debt have come to the fore during the last couple of centuries. Alongside irredeemable fiat currency, itself with a patchy track record for reliability in exchange value, hence a patchy record of reliability in providing the services sought.

3 Goodhart (1988).
4 Central Bank Governance Group (2009, pp. 19–20).
5 See for example, Davies (1994). See also David Graeber (2011), for emphasis on debt and debt instruments.
6 See for example Gorton (2016).

The point is that such histories mingle the roles of money and credit instruments and the institutions that are involved in their supply. Catastrophic breakdowns are commonplace, in the wake of which people search for and then experiment with arrangements that may (hopefully) be less frail. Yet certain types of breakdown repeat themselves. One is the collapse in the exchange value of the thing that that community has adopted as the medium of exchange and store of value – that is, runaway inflation. Another is breakdowns in the *machinery* of the financial system – of the institutions, and of the systems and networks that connect them. Such breakdowns impede economic exchange, and also lead to collapses in stores of value. Both types of breakdowns cause harm to the users of the monetary system.

Through time, governments have played an increasing role in the organisation of the monetary system. Presumably, the reason for increasing government involvement even as the power of monarchs diminished relates to the public good that a stable and reliable monetary system can provide. That public good is the facilitation of economic exchange across distances, between strangers, and through time. Such a monetary system is not something of just marginal value. Indeed, some argue that the quality of the monetary system is a key ingredient of successful civilisations.[7]

The telephoto lens of history makes it natural to think that this high-level public good encompasses all elements of the system, and all the main sources of instability and unreliability. Yet, modern discussions of the financial system, using much shorter focal length lenses, still predominantly divide up or isolate various elements for separate discussion:

- There is monetary policy, which focusses on constructing and fine tuning fiat currency arrangements to assure predictability of exchange values.
- There is the regulation of financial intermediaries and financial infrastructures – the machinery of the financial system – which focusses on the safety and reliability of the individual parts of the machine.
- And now there is the macroprudential angle, focussing on interactions between individual components of the machinery of the financial system, and how they interact collectively with the rest of the economy. This is a step ahead, because the focus is on interactions. However, macroprudential policy discussions do not yet shed much light on interactions between the workings of the financial system machinery and the workings of fiat currency arrangements.

Of course it can be useful to divide up complex matters into more comprehensible parts, to be able to think about them more clearly. However, problems can arise if segmentation ends up burying crucial aspects. Apart from the intuition that a single public good should be analysed in an integrated manner, there are multiple indications that we might be burying things we should not be:

- The Global Financial Crisis (GFC) showed that price stability and prudential regulation of the insitututional components of the financial system does not assure the stabilty of the monetary system. The resultant losses in employment and real income have been very substantial.
- The available policy instruments do not divide up neatly along the lines we use to segment the discussion. Interest rates affect incentives to take risk. Regulations of various types change the effective cost of credit and the resulting signals about whether to spend now, or later. There are not unique "transmission mechanisms" for price and financial stability.
- Our regulatory policy instruments are neither sufficiently powerful nor sufficiently well understood that their gentle application will always be successful. At times, even energetic, well-timed regulatory efforts to lean against excesses can be overwhelmed.

7 Ferguson (2008).

Collective enthusiasms – occasionally manias – are formidable forces. As John Kay noted in the Financial Times, regulators often get blamed for the stupidity of crowds where that stupidity overwhelms the best effort of regulatory agencies. And if not overwhelmed by the crowd, regulatory actions can still reach a point where adverse side-effects – regulatory arbitrage, distortions – become too large. Using interest rates to lean against collective enthusiasms that manifest in strong leverage and asset price movements may often be inefficient, or perhaps net negative, relative to using effective regulatory instruments.[8] But when regulatory instruments are themselves constrained, perhaps the cost-benefit analysis changes.

- Business cycles and financial cycles do not always tidily align. Recently, a number of central banks have confronted a dilemma caused by an apparent lack of aggregate demand, as evidenced in persistent sub-target inflation, combined with concern that strongly stimulatory monetary policy is disproportionately feeding financial risk-taking. (For some reason, the boost to real sector risk taking and to consumption has been muted relative to the boost to financial risk-taking. At the same time, resultant financial asset prices can apparently remain persistently out of line with the future incomes able to be generated by the underlying real assets.) In the last couple of decades, we have witnessed episodes of financial bubbles coinciding with increasing pressures on real resources that have not manifested in inflation.
- Yet there are also important causal connections to consider. Persistently low interest rates – even relative to a declining neutral interest rates, and almost certainly relative to the representative agent's rate of time preference – may well have induced risk-taking that has evolved into bubbles.[9]

In general, there seem to be plenty of indications that the pursuit of monetary stability does not neatly subdivide into money, institutions and systemic linkages. Monetary stability and financial stability are not separate topics. In principle, considering all relevant policy instruments together *should* lead to better results than segmenting the use of these instruments.

3 Why the emphasis on spelling out mandates?

I have emphasised the desirability of spelling out mandates, and in particular the accompanying objectives, with a great amount of clarity. Yet it is true, as a number of you have pointed out, that our monetary policy objectives are not very precise, at least in law, and that imprecision did not stop the independent exercise of monetary policy from acquiring widespread legitimacy, at least post-Volker and pre-GFC.

Indeed, many central banks do not have price stability specified as an objective either in their constitutions or their statutes. Around a fifth of BIS member are in this position. Such central banks are directed to use their powers in pursuit of monetary stability, stability in the exchange value of the currency, or the general welfare of society.[10] These words could be taken to refer to stabilising a certain form of inflation at relatively low levels – and are interpreted that way in several cases (for example, Australia, Chile, Israel, Malaysia, Thailand, South Africa) – but that is not the only admissible interpretation. Of the greater number that do have price stability specified in law as the prime monetary policy objective, in no cases does the law identify what is meant by "price stability". It has become acceptable that such clarifying details are set out in non-statutory form.[11]

8 See for example Svensson (2016).

9 Juselius et al. (2016).

10 Central Bank Governance Group (2009), Chapter 2.

11 In a small number of cases, such as New Zealand and the United Kingdom, setting out the clarifying details in non-statutory form is in fact a requirement of the law. But these requirements do not always specify which details, simply that details need to be provided, and in a particular form (a Policy Targets Agreement, and a Chancellor's Remit letter, respectively).

At the same time, as Philip Wallach (2015) points out, legitimacy is not automatically a consequence of law, and legality does not assure legitimacy. There are plenty of laws that are simply not implemented, or when implemented invoke widespread distaste or resistance because they are just contrary to public opinion. In the specific context of central banking, Lastra (2015, p30) writes "Central banks inhabit a 'world of policy'. This does not mean that there is no law. It means that the law has generally played a limited role in central banking operations."[12]

I would argue, however, that with respect to new, expanded and more active financial stability mandates, legitimacy almost requires legislative action beyond what we have observed to date. It is not inconceivable that such legitimacy would be acquired over time, as was the case with monetary policy and price stability. It is rather that two characteristics of financial stability policy make the progressive acquisition of credibility and legitimacy much more difficult, and probably dangerously slow. These two characteristics are:

- Financial stability policy principally uses regulatory powers and it is in the nature of regulation that incidence is selective (if not arbitrary) and that unintended distortions follow.
- The number of dimensions of fully-specified financial stability objectives is far higher than the number of dimensions of fully-specified monetary stability ones.

I will develop these thoughts further in a moment. But let me first finish the case for making the effort to create legislative support for new financial stability policies by reiterating that it is the unilateral repurposing of existing delegated powers that provides the greatest challenge to legitimacy. Action by the legislature to condone that repurposing perhaps matters more than the resulting law.

4 The complexity of financial stability objectives: regulation and multi-dimensionality

There are several things that are particularly troublesome when it comes to being explicit about financial stability mandates:

- Identifying what specific aspects of stability/instability give rise to a case for public policy intervention.
- Quantifying that, in a manner that allows statements about how much stability is sought, and how far policy instruments can be used.
- For the greatest part, these are regulatory instruments, and as such warrant special attention to considerations of fairness, distribution and economic efficiency.
- Failures hurt public finances very directly.
- All in all, compared with monetary policy objectives, financial stability objectives have very considerable multidimensionality.

Let me spend a few minutes on the multidimensionality of financial stability objectives, as it is under discussion.

A fully-articulated monetary policy objective typically has very few dimensions, and these few can be ranked. Price stability is usually primary, with avoiding unnecessary harm to output and employment being secondary. Some concern for avoiding harm to financial stability might now be added, though without the ability to quantify. Price stability is not usually quantified in law, but often is in extra-statutory strategic statements.

12 Lastra (2015).

In contrast, a fully-articulated financial stability objective would include, at a minimum:

- An indication of what aspects of financial stability are considered important (for example, an objective might be framed in terms of the resilience of the financial system as a whole to shocks, such that self-reinforcing dynamics do not bring essential services down for sustained periods).
- Special concern for the protection of naïve creditors.
- The desirability of informed investors anticipating the possibility of loss in their behaviour.
- Concern that the fiscal position is protected.
- Protection of the property rights of investors in financial services, conditional on the avoidance of moral hazard.
- Productive and especially dynamic efficiency, such that financial services efficiently support economic progress.
- Respect for the rights of citizens of other jurisdictions.
- And, where the implementing agency has other functions, the non-interference with those functions, or some indication of how tradeoffs are to be managed.

For economists thinking about how one might boil the policy task down into a tidy policy reaction function, so as to avoid the messy politics of discretion, such a list will seem unreasonably detailed, unnecessarily complicated. But to recall, we are talking primarily about the use of powerful regulatory tools that directly impact peoples' options, their freedom to act. We are not just playing with agents' incentives to consume earlier or later, leaving available all the extant options. Concern about side effects, and recognition of the existence of tradeoffs, is essential. What responsible legislator would not actively inquire into the likely consequences of delegating extensive regulatory powers along all of these dimensions? And what responsible legislator would sign off on such delegations without some assurances on most or all of these fronts?

Hesitation to provide additional powers in legislation can, I suggest, be traced in significant part to our inability to provide such assurances. We typically do not even volunteer the relevance of all these aspects of financial stability policy. And we are lost when it comes to identifying how the tradeoffs would be managed. This is a major problem, since the tradeoffs within this list are many and significant, and legislators know that (at least in their gut).

Consider the last on the list, in the context of central banks being the agency to which the financial stability function is delegated. Even quite recently, it was standard to hear the claim from central bankers that there are no tradeoffs to be considered. In the long run, all is consistent: financial and macroeconomic stability are mutually compatible. Yet it has been clear for some time now that the Fed – to highlight just one example – has had to think hard about the risks that persistently low interest rates pose to future financial stability. And the literature on the location of microprudential regulatory functions has much discussion of potential short run conflicts of interest between financial and monetary stability objectives. The separation of decision-making on the Single Supervisory Mechanism from that on monetary policy within the ECB's structure is based on the possibility that such conflicts will arise. Trust in the ability of those seeking delegated powers is not enhanced by their denial, non-recognition or even slow recognition of important trade-offs.

But how can one reasonably write such a complicated tradeoff structure into law, let alone specify the tradeoffs, when we don't know them? Even if we had a first guess at how the complicated tradeoffs should be managed, surely the passage of time would quickly prove us wrong, leaving us back on the horns of the same dilemma? In my closing section, I would like to offer a way out.

5 More explicit yet flexible statutory mandates

A little-noticed piece of law enacted in 2009 in the United Kingdom provides the framework of the solution I think we are looking for. This piece of legislation is the Banking Act, the legislation that created the United Kingdom's special resolution regime.[13] Section 4 of that act specifies no less than five objectives that the resolution authorities must consider when using the powers provided under that act. These five objectives are:

- to protect and enhance the stability of the financial systems of the United Kingdom, with particular reference to the continuity of banking services;
- to protect and enhance public confidence in the stability of the banking systems of the United Kingdom;
- to protect depositors;
- to protect public funds;
- to avoid interfering with property rights in contravention of EU treaties.

Because the Act has a narrower ambit than financial stability policy in general, the list of objectives here is shorter than the list I provided earlier. But the lists overlap considerably, and both are multidimensional. Importantly, there are internal conflicts within each list; there are obvious tradeoffs.

After setting out the (potentially conflicting) objectives, the Act states that "the order in which the objectives are listed in this section is not significant; they are to be balanced as appropriate in each case". But it does not leave it there. It goes on to require, in the next section, the creation of a "Code of Practice" − a high level strategy statement would be a better description − that inter alia provides guidance on:

- how the objectives are to be understood and achieved;
- the choice between different options; and
- the advice provided by one relevant authority to other relevant authorities about how and when the special resolution powers are to be used.

This Code of Practice is to be issued by the Treasury in consultation with the Bank of England (as the central bank, as the financial supervisor, and as the resolution agency) and the manager of the deposit insurance scheme. And the Act envisages that the Code will be revised and reissued.

This governance structure allows the legislature to set out the minimum range of considerations that *must* be taken into account when delegated powers are used, without attempting to rank them or pre-specify tradeoffs when these things are neither known nor likely to be stable. But the legislature also requires the use of a public device that fills in the blanks using the best knowledge available at the time, at least as agreed between the relevant expert agencies of government.

6 Concluding remarks

I started out by worrying that the creation of additional regulatory powers and the repurposing of existing ones for deployment by agencies at arms' length from electoral sanction will lead to a crisis of legitimacy if the purposes for which these powers are to be used are not better spelled out. Especially where the relevant agencies have other powers pointed at other objectives that may not fully be defined. I argued that one of the problems

13 I point to this Act, rather than the later (2012) Financial Services Act that established the governance arrangements for financial stability policy in the United Kingdom, because the Banking Act provides the cleaner exemplar for legislation involving multidimensional objectives. The Financial Services Act contains several echoes of the Banking Act structure, and has the virtues of attempting to clarify what is meant by "financial stability", of setting out a range of objectives, of specifying secondary law and non-statutory devices for updating the working interpretations of the requirements of the Act, and of requiring consultation between the relevant public agencies on specific matters.

is the significant multidimensionality of financial stability objectives, a multidimensionality that is not much acknowledged by the experts but is surely instinctively understood by legislators.

To better ensure legitimacy, it seems necessary that substantial new powers, and especially the repurposing of existing powers, be endorsed by the legislature, in a manner that attends to this multidimensionality. For the most part, new law in this area does not do that. Financial stability objectives, some of which have been introduced quite recently, usually do not define the aspects of stability that are thought important, let alone identify conflicting objectives.

But rather than providing a counsel of despair, my purpose is to provide a counsel of hope. We need not wait until our understanding of the relevant economics has much improved − though that is important − before writing central bank mandates for financial stability policy that are more likely to be seen as politically legitimate. There are governance structures available that show the way.

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