A coming crisis of legitimacy?

REMARKS TO A SVERIGES RIKSBANK CONFERENCE ON

RETHINKING THE CENTRAL BANK'S MANDATE

STOCKHOLM 3-4 JUNE 2016

DAVID ARCHER

(HEAD, CENTRAL BANKING STUDIES, BIS AND SECRETARY TO THE CENTRAL BANK GOVERNANCE GROUP, ALTHOUGH THESE REMARKS ARE PERSONAL AND NOT TO BE ATTRIBUTED TO EITHER OF THESE INSTITUTIONS)

Overview

Focus on the financial stability mandates.

Make the case that many central banks are at risk of a crisis of legitimacy, with respect to new macro financial stability mandates. The issue is an inability to write clear objectives.

Finish by pointing to an approach taken in the UK that might be used as a template elsewhere.

The legitimacy problem

The context is the delegation of far-reaching powers (transactional and especially regulatory) without clearly stated purpose or, as a consequence, obvious limitations on how those powers might be used.

Many central banks already have a wide range of regulatory powers. Most see the need for new instruments for financial stability. Yet they find it difficult to articulate clearly the circumstances in which such powers would be used, to what extent, and when their use would be inappropriate.

There is also a difficulty in describing how new powers would be used in relation to the monetary stability objective. And monetary stability instruments in relation to financial stability.

The legitimacy problem (cont.)

Crucially, existing powers are being re-purposed. One might reasonably expect legislatures to be bothered when powers delegated for one purpose unilaterally are used for another. Here legitimacy risks are biggest.

Not a good time

Testing the boundaries of society's tolerance for unilateral reinterpretation of mandates is inevitable. Circumstances change, sometimes rapidly, and the political process is clumsy.

But tolerance for testing may currently be especially low:

- Unconventional monetary policies have already pushed mandate boundaries. Signs of political discomfort are obvious in Germany, the US, and elsewhere.
- Trust in politics and the institutions of government is falling, quite generally.

Financial independence is becoming less assured. Some central banks may be forced into negotiations over payment for fiscal agency services they provide.

Should central banks be in this game?

Central banks are not encroaching on territory where they have no place.

Since the inception of central banking, in different & evolving ways central banks have been key part of mankind's search for a stable, reliable monetary exchange technology.

That search has always involved seeking out reliable institutions of exchange. The *system* of financial intermediation and the exchange value of monetary tokens can both be sources of instability. In history, the stability of exchange values and of the mechanisms of intermediation have been interdependent.

But that's not the basis on which central banks (re)acquired distance from daily political command. That was based on a narrower conception of the central bank task – the part focused on stability of the exchange value of money.

Unclear financial stability objectives?

In many countries, “financial stability” (or similar words) has been added to the central bank’s legal objectives quite recently. Immediately pre-crisis, around two-thirds had something like a financial stability objective. Now it is more like four-fifths.

But most of the pre-existing cases were related to payment systems oversight and bank supervision – narrower concepts than we now want those words to mean.

And in a substantial proportion of the pre-existing cases, the financial stability objective is submerged, or at least made secondary to the monetary stability objective.

Important central banks like the Fed and Bank of England had no financial stability objective. The ESCB central banks have the “task” of contributing to the smooth conduct of policies conducted by other authorities.

Unclear financial stability objectives (continued)?

Very few laws attempt to say what is meant by “financial stability”.

Very few even hint at which aspects of changing financial conditions are bad, dangerous, as opposed to benign or good.

None (that I am aware of) provide any indication of how much stability (however that is defined) is sought.

Nor could financial stability specialists provide solid answers to these questions, if asked by legal draftsmen. They certainly would struggle with questions about side effects and the incidence of costs and benefits.

The horns of a dilemma

The lack of clear objectives, indeed the absence of sufficient knowledge about these things, puts central bankers (and others with access to the instruments) in a real dilemma.

- We have plenty of evidence of the costs of disruption to the system of monetary exchange.
- Central banks were born to play core roles in creating reliable systems of monetary exchange.
- We tend to believe, genuinely, that we can use these regulatory powers to good effect.
- Waiting until we can prove the case and fully articulate the tradeoffs is a counsel of perfection, where perfection really is the enemy of the good.
- In any case, those who could have acted, but did not, will be held to account when things go wrong.

The horns of a old dilemma?

This seems reminiscent of earlier times when achieving and maintaining price stability seemed really difficult. New Zealand adopted inflation targeting when the relevant theory was in its infancy, and the costs of the attempt were widely expected to be overwhelming. Nor was the objective clearly defined: “stability in the general level of prices”.

The RBNZ’s new law simply said: there is the objective … go and flesh out what it means and how you will go about it … do this jointly with the Minister of Finance … and disclose what you are doing.

But the horns of the current dilemma are distinctly sharper.

- Regulatory instruments play a much bigger role. For those directly targeted, the intervention in choice-making is much greater and distortions are much bigger.
- Financial stability objectives have many more dimensions – tradeoffs – to deal with.

Dimensionality

Monetary policy objectives have perhaps two dimensions: the stability of inflation around target and the stability of real activity around its exogenous trend.

A reasonably-specified financial stability objective would surely have at least the following dimensions:

- Some indication of the particular aspects of financial variations that we want to dampen, or bound
- Special consideration to be given for the protection of naïve creditors
- A requirement that informed investors bear risk
- Concern for the protection of the public finances
- Concern for the property rights of owners of financial services
- Avoidance of moral hazard

……

Dimensionality (continued)

- Concern for the productive and especially dynamic efficiency of financial services, such that they support economic progress
- Respect for the rights of citizens of other jurisdictions
- Where the implementing agency has other functions, non-interference with those functions, or some indication of how tradeoffs are to be managed.

Not easily coded into a rules-based operating framework. But necessary to address the concerns of legislators, of society, when delegating far-reaching regulatory powers.

Not acknowledging the relevance of all these dimensions presumably leaves legislators suspicious of delegations, weakening the legitimacy of strong actions.

Outright denial of the relevance of tradeoffs ought to make one suspicious. Consider the tendency of central bankers to deny tradeoffs between monetary and financial stability objectives ("fully consistent in the long run") vs. current central bank policy dilemmas.

A way forward

The design problem: an objective statement in law that addresses legislators' multiple concerns but that is also feasible and flexible.

A useful model exists in a little-noticed piece of UK law: the 2009 Banking Act.

- Creates the framework for the special resolution regime (SRR, a related subject area, similar set of actors, but not identical)
- Specifies multiple (five) objectives that conflict
- Specifies the process by which the extant interpretation of those objectives, and the treatment of tradeoffs, is to be determined and updated

A way forward (continued)

The Banking Act **objectives** (= considerations that the relevant authorities must evaluate when using SRR powers):

- Protect and enhance the stability of the financial systems of the UK, with particular reference to the continuity of banking services
- Protect and enhance public confidence in the stability of banking systems of the UK
- Protect depositors
- Protect public funds
- Avoid interfering with property rights in contravention of EU treaties

- “The order in which these objectives are listed in this section is not significant; they are to be balanced as appropriate in each case”

A way forward (continued)

The Banking Act **process** (for interpreting objectives and tradeoffs):

- The Treasury is required to create and publish a "Code of Practice" – perhaps better thought of as a Woodford level 2 statement on policy conduct – in consultation with the other authorities
- That Code is to provide guidance on:
  - How the objectives are to be understood and achieved
  - The choice between different options for resolution
  - Advice-giving by one relevant authority to other relevant authorities about how and when the SRR powers are to be used.
- The Code is envisaged as a live document that will be revised and reissued as required
- The accountability of the relevant authorities for the way that they use the delegated powers is in relation to all five objectives, as interpreted by the Code.

A way forward (continued)

The approach allows Parliament to delegate powers within a framework where the full range of considerations thought relevant to the use of those powers can be specified without attempting to codify, in a hard to change manner, how they are to be weighed.

Democratic legitimacy is aided by:

- allowing for multidimensional objectives
- specifying a flexible but formal public process by which tradeoffs assessments are to be guided
- the involvement of the political authorities (the Treasury) in interpreting the objectives.

Concluding remarks

The financial stability dimension of central banking has long historical precedent, as part of central banks' place in mankind's search for a reliable and effective monetary system.

But this role was not prominent when central banks were given greater independence from daily political control.

Adding the role back in, and repurposing existing instruments for its pursuit, risks a crisis of legitimacy. Unless legislatures endorse that repurposing in a way that addresses the many relevant dimensions of society's objectives in this area.

That seems almost impossible, especially given our current state of knowledge.

But a useful model exists.