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1 *Central banking as governance*

Don't fight the Fed!

Wall Street aphorism

It is well enough that the people of the nation do not understand our banking and monetary system for, if they did, I believe there would be a revolution before tomorrow morning.

Henry Ford Sr.

Governance is thus a system of rule that is as dependent on intersubjective meanings as on formally sanctioned constitutions and charters.

James N. Rosenau

The literature on central banking is currently dominated by references to the need for, or attempts by central banks to attain, "credibility" with the financial markets. The vehicles by which central banks are to attain this credibility are typically identified by monetary economists and central bankers as "independence" and "transparency." Independent central banks have the authority to conduct monetary policy without interference or political pressure from the finance ministry or the government. This independence can be granted as full "operational independence" where the choice of the vehicles by which monetary policy is executed is left to the discretion of the central bank. It can also be granted in the form of "goal independence" where the level of domestic inflation to be tolerated as consistent with the mandate of the central bank to maintain "price stability" is also left to the discretion of the central bank.

Possession of either or both of these forms of independence leaves the central bank in command of enormous authority over, for example, the domestic money supply and the supply and price of short-term credit to the banking sector, as well as the price of money in the short-term money markets. It also permits central banks to

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delegate authority to other actors, including private actors in the financial markets.

The neoclassical literature on monetary economics and central banking tells us that this independence from government pressure to print money to monetize debt or to stimulate the domestic economy provides the central bank and its monetary policy with "credibility" with the financial markets, particularly with the foreign exchange (FOREX) and bond markets. An unfortunate source of confusion in this literature arises from the fact that the models from which the assertions that central banks are tempted to generate excess monetary stimulus are drawn are rational choice theoretic. However, the credibility that central banks require to resolve these problems can only result from the establishment of intersubjectively shared social understandings between central bankers and market actors.

Credibility is a social relationship as much as (or rather more than) an economic relationship. When we are "credible" we are trustworthy, and when we are trustworthy we can be relied upon to meet our commitments and to keep our promises. Central banks are entrusted with the guardianship of price stability. Central banks are "credible" when market actors and the public trust central bankers to act to uphold their promise to maintain the purchasing power of the money they issue. In our contemporary era of fiat money in which we lack a capacity to measure the value of money against an external standard – such as gold or some other valuable commodity in limited supply – all money is fiat money. Money's value is stipulated by fiat, and the central bank explicitly or implicitly pledges to maintain that fiat value. Thus money is a promise.

As a consequence of this social nature of money, the "rational expectations" of market actors cannot help them in making carefully calculated, rationally determined decisions regarding the credibility of the social understandings that they share intersubjectively with governors of central banks. The "utility" of "rationality" encounters severe limitations as a basis for market decisions in this context. Market actors have, then, to make a choice. They can either trust the central bank's promise of stable money – and thereby loan their own money to governments, commercial enterprises, or municipalities at a small premium – or they can decline to trust the promise of stable money and demand a high-risk premium to compensate them for the devaluation their own money might suffer while out on loan.

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Market actors will consequently base their investment decisions on "intersubjective expectations"[1] rather than "rational expectations" and will look to central banks (and to one another) for signals of continuity of the validity of the promise that the money issued by the central bank represents.

Central banks, anxious to reinforce hard-earned intersubjective expectations of market trust in their money's credibility, will wish to avoid disappointing market actors lest their credibility be lost, and their reputations as trustworthy guardians of price stability suffer. Surprises will always disappoint market actors. Thus we see the contemporary move toward increasingly independent (thus ostensibly "credible") central banks, toward enhancing the "transparency" *vis-à-vis* market actors of central bank expectations regarding inflationary pressures in the economy, and the transparency of banks' monetary policy decision-making procedures. These moves toward enhanced transparency generate increasingly sophisticated central bank communications strategies that are directed toward market actors in the hope of steering their intersubjective expectations, shared with other market actors, of the future direction of monetary policy. In this way central bankers hope to enlist market actors in reinforcing the direction of central bank monetary policy *vis-à-vis* long-term interest rates. Market actors may thereby be enlisted as monetary policy force-multipliers, because these long-term rates are determined not by the central bank but by private actors with capital to lend in the disintermediated bond markets.

To the extent that independent central banks are successful in establishing "credible" intersubjective expectations with market actors that their monetary policy will maintain price stability – and to the extent that they are successful in establishing "transparent" intersubjective expectations with market actors who consequently trust that central bank signals will point them toward the future direction of monetary policy – then institutional convergence toward central bank independence and transparency constitutes an increasingly effective instrument of global financial governance.

[1] These are related to what Blyth calls "conventional expectations." See Mark Blyth, "The Political Power of Financial Ideas: Transparency, Risk, and Distribution in Global Finance" in Jonathan Kirshner (ed.) *Monetary Orders: Ambiguous Economics, Ubiquitous Politics* (Ithaca, NY and London: Cornell University Press, 2003), pp. 239–59.

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Governance

This introductory chapter, while conceptually important and summative, is very brief. It introduces the notion that current trends toward institutional convergence in central banking – specifically recent moves toward increased central bank independence and transparency – are the bases for establishing a new system of monetary governance. This is developed as a system of multilevel governance, with contributions from financial and policy actors that have been allocated various forms of constituted authority that will later be developed as "deontic powers" in the system of governance.

In a growing literature on the topic of governance, the meaning which is most useful for the explication of the relations of global financial governance in general, and monetary governance in particular, is social and relational. The writings of Benjamin Cohen and James Rosenau provide a strong point of departure. While institutions are often implicated in social relations of governance, Benjamin Cohen points out that:

> Governance . . . does not necessarily demand the tangible institutions of government. It may not even call for the presence of explicit actors, whether state-sponsored or private, to take responsibility for rule-making or enforcement. To suffice, all that governance really needs is a valid social consensus on relevant rights and values.[2]

Governance is therefore an inherently social, relational phenomenon. While governance relations may develop institutional forms in practice, over time they need not rely on institutions of government. As Rosenau has developed the concept:

> Governance refers to activities backed by shared goals that may or may not derive from legal and formally prescribed responsibilities and that do not necessarily rely on police powers to overcome defiance and obtain compliance. Governance . . . is a more encompassing phenomenon than government. It embraces government institutions, but it also subsumes informal, non-governmental mechanisms . . . Governance is thus a system of rule that is as *dependent on intersubjective meanings* as on formally sanctioned constitutions and charters.[3]

[2] Benjamin J. Cohen, *The Geography of Money* (Ithaca, NY: Cornell University Press, 1998), p. 145.

[3] James N. Rosenau, "Governance, Order, and Change in World Politics" in James N. Rosenau and Ernst-Otto Czempiel (eds.) *Governance Without*

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Global financial governance – and particularly monetary governance – is argued in this book to be a system of rule based on systems of distributed authority networks among both public and private actors that are strongly dependent upon intersubjectively shared meanings. As it is a system with multiple sites of authority, it is a decentralized system of multilevel governance.[4] As such, the sites, or locations, of authority are found at numerous levels of organization. I argue that authority over monetary governance is found at the national level, at the supranational level, and at both the public and private transnational levels.

At the national level, authority over monetary governance is found in the executive branch of many governments, particularly in the finance ministries and in central banks. Authority at the national level over monetary governance may be found in abundance particularly among central banks which have been granted independence by the government. A major argument of this book is that the emerging system of global monetary governance is designed to drive governance capacity down to the lowest possible level in a system of multilevel governance – namely the national level – through institutional convergence toward independent (and preferably "transparent") central banks. At the national level the system of governance is represented by increasingly independent, variably transparent central banks and their communications strategies, as well as foreign ministries, and national fiscal and political authorities. Central banks have been allocated an enormous range of "deontic powers" ascribed in this system of governance. These will be developed briefly later in this chapter, and described in considerable detail in chapter 3. For now, it should suffice to add that "deontic powers" are the result of "deontologies" and thus are forms of authority (or governance capacity) resulting from collective assignment of status functions.

At the public transnational level these actors include the International Monetary Fund (IMF) and the Bank for International Settlements (BIS) as foci of fiscal policy surveillance and enforcement, and of coordination of central bank policy respectively. While these

Government: Order and Change in World Politics (Cambridge: Cambridge University Press, 1992), p. 4, and quoted in Cohen, *The Geography of Money*. Emphasis added.

[4] For the etymology of this terminology from the literature on European integration see e.g. Lisbet Hooghe and Gary Marks, *Multilevel Governance and European Integration* (Lanham, MD: Rowman and Littlefield, 2001).

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public transnational actors serve as sources of the neoliberal ideational infrastructure of the emerging system of monetary governance, and they are briefly discussed later in the book, the focus in this work is on explicit institutions and "institutional facts" rather than broad historical ideational changes that have prepared the way for the emerging system of financial and monetary governance. The important ideational transformations that have led to the eclipse of Keynesian economic ideas,[5] the collapse of the Bretton Woods gold-exchange standard,[6] and the transformation of the various public international financial institutions such as the IMF,[7] and even the BIS,[8] into public transnational champions of neoliberal ideas and prescriptions, have been well studied by others in an exciting and recently developing constructivist literature on international political economy. But the present work would suggest that while transformation of these public international institutions has been an important enabling condition for the emerging system of monetary governance, the major agencies and mechanisms of governance are located elsewhere. They are located largely at the national and private transnational levels of governance.

At the private transnational level the emerging system of governance includes financial market actors, particularly participants in the FOREX markets and the disintermediated bond markets. These actors are allocated authority to adjudicate the "credibility" of fiscal and monetary policy through market judgments – as well as private bond rating agencies like Moody's and Standard and Poor's who are allocated the deontic power to "grade" that credibility on a ranked scale for use by participants in the markets for sovereign, corporate, and municipal debt instruments.

[5] Mark Blyth, *Great Transformations: Economic Ideas and Institutional Change in the Twentieth Century* (Cambridge: Cambridge University Press, 2002) and Wesley W. Widmaier, "The Social Construction of the 'Impossible Trinity': The Intersubjective Bases of Monetary Cooperation" *International Studies Quarterly* 48 (2004): 433–53.

[6] Eric Helleiner, *States and the Reemergence of Global Finance: From Bretton Woods to the 1990s* (Ithaca, NY: Cornell University Press, 1994) and Jacqueline Best, *The Limits of Transparency: Ambiguity and the History of International Finance* (Ithaca, NY: Cornell University Press, 2005).

[7] Rawi Abdelal, *Capital Rules: The Construction of Global Finance* (Cambridge, MA: Harvard University Press, 2007).

[8] Ethan B. Kapstein, *Governing the Global Economy: International Finance and the State* (Cambridge, MA: Harvard University Press, 1984).

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At the supranational level the emerging system of monetary governance includes a new supranational European Central Bank (ECB) and the ancillary system of national European central banks. The burgeoning use of the euro as a global reserve currency and as a vehicle for currency substitution introduces a supranational level of governance into the system, which does not, however, impact all actors equally. The ECB has a mandate enshrined in the Treaty of the European Union (EU) to ensure price stability and it operates procedurally in accordance with its supranational charter. This mandate can only be overturned by renegotiation of the treaty and ratification of a two-thirds majority of the members of the EU.

The success of this emerging global system of multilevel monetary governance relies on policy convergence as "best practice" as defined by epistemic communities of monetary economists and central bankers. The effect (and it is highly likely, the intent) of these efforts toward policy convergence is to drive the most critical governance structures down to the lowest possible, national, level of governance so that they may provide uniformly effective impetus toward price stability throughout the international monetary system. In the chapters to follow I emphasize the importance of establishing money as a social, institutional fact – rather than a brute or observational fact – for correctly specifying the power of central banking as a governance mechanism. The concluding chapter will sketch out the major forms of constituted authority (which will be developed as "deontic powers" in accordance with John Searle's institutional philosophy) that constitute the emerging system of global monetary governance in the era of fiat money and floating exchange-rate regimes. Central banks (monetary institutions at the national level of governance) have an important role to play in generating and institutionalizing this system of monetary governance.

Plan of the book

I will now proceed with the plan of the book. As I am developing a constructivist theory of monetary relations and monetary governance I will be required to equip the reader with the proper conceptual apparatus with which to apprehend monetary power relations as social relations. Thus the second and third chapters will critique orthodox monetary theory for its inadequacies in helping us to properly apprehend the social nature of money and monetary relations, and the nature of the

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institutional facts upon which all monetary relations and institutions are built. Subsequent chapters will build upon a fresh conceptual apparatus that is designed to flesh out the details of the emerging system of monetary relations based upon the authority relations constituted in no small measure by central bank "credibility" and "transparency" strategies.

Chapter 2 will develop the social character of money and central bank finance. I critique orthodox monetary theory's basis in the commodity theory of money and its quantity theory variant, as well as its view of money as a "neutral veil" in the "real economy." I will develop and critique the historical and intellectual antecedents of orthodox monetary theory's three "functions" of money as a "store of value," a "medium of exchange," and a "unit of account."

The deflationary monetary systems of the classical gold standard and monetarism will be demonstrated to spring from the "store of value" function of orthodox theory. The gold standard system arose from the assumptions of the commodity theory of money, and monetarism from the quantity theory of money. Orthodox theory's view of money as a medium of exchange impels the demand for money creation and empowers central banks to regulate its supply. The continued search for a new "nominal anchor" for the international monetary system – with the demise of metallic standards and the non-viability of monetarism in the light of monetary velocities and the proliferation of "near monies" – is developed as a major intellectual legacy resulting from the orthodox view of money as a unit of account.

Orthodox monetary theory misses several insights crucial to a proper understanding of the nature of money, not least that money's value in the era of modern central banking is an intersubjective scale of value. In this context, the value of money is constantly interpreted and reinterpreted. Thus in practice money's value is determined domestically by central bank fiat and internationally by negotiation of social relations of trust between central banks and market actors. Thus money's social character is developed as a promise between central banks, governments, and purchasers of government securities, as well as users of money among the general public. In later chapters this social character of money will be demonstrated to have enormous consequences for the construction of the social relations of governance of monetary orders.

Chapter 3 presents the major theoretical insights critical to the constructivist development of central banking as a social institution

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and the social character of money. I draw upon the institutional philosophy of John Searle in developing the international financial realm as a realm of social, institutional facts that is rigorously distinguishable from the realm of brute or observational facts. Searle's work illustrates how institutional facts are generated by the collective assignment of status functions to people, institutions, and objects that thereby acquire deontic powers (authority resulting from an institutional deontology) that are explicable only through a constitutive, rather than a causal, logic. These power and authority relations are institutional facts. Institutions are constructed from deontic powers ascribed by actors to other actors, by collective assignment of status functions (by fiat). They engender creation of constitutive rules. Searle demonstrates

> The creation of an *institutional fact* is, thus, the collective assignment of a status function. The typical point of the creation of institutional facts by assigning status functions is *to create deontic powers* . . . we have created a situation in which we accept that a person S who stands in the appropriate relation to X is such that (S has power (S does A)).[9]

The concept of money as an institution will be developed with recourse to these foundational constructivist concepts that help us to understand the constitution of social kinds and their distinction from natural kinds. The theory is then applied to develop the deontic powers of central banks. These include (but are not limited to) the deontic powers of (1) money creation and destruction in the process of setting interest rates, (2) liquidity creation and risk socialization powers (lender of last resort functions), (3) powers to value and revalue the domestic product of the nation through exchange-rate and foreign reserves management, (4) the power to monetize government debt, and (5) powers of credit allocation via government directed lending and "window guidance." Each of these deontic powers of central banks is developed with recourse to the theory in some detail.

Chapter 3 concludes with a discussion of why we should trouble to develop a socialized view of central banking and international monetary systems. It matters because understanding money, credit, and

[9] John R. Searle, "What is an Institution?" *Journal of Institutional Economics* 1(1) (2005): 21–2. Emphasis added.

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central banks as social institutions permits us to begin to discover the monetary and economic realms as rule-governed spheres of social action. It helps us to make an analytic cut into the rule-based architecture of international monetary affairs. This rule-based realm has always been governed by an institutional logic of institutional practices in response to institutional facts and the constitutive rules that arrange these into social reality, rather than by the wholly uncoordinated actions of means–ends instrumentally rational actors. We need a "logic of appropriateness" intersubjectively shared between actors, and not simply a "logic of instrumentalism" individually endogenized by atomized rational individuals, to explain both central bank behavior and market behavior in national and international monetary affairs.

Chapter 4 will analytically relate and contrast the notion of deontic power as developed from Searle's institutional philosophy to currently developing concepts of power in the extant constructivist literature in international relations, as well as to current developments in the analysis of the notion of international monetary power. Deontic power will be related to but distinguished from the useful taxonomy of power developed within explicitly constructivist theories, and the deontic powers of central banks developed within chapter 3 will be further analyzed within this taxonomy in order to explore the constitutive power relations that central banks and their interaction partners engender within monetary power relations more fully.

The international monetary order has always been rule based. Its history is the history of the construction and demolition of rules: constitutive and regulative, explicit and tacit, substantive and procedural, national and transnational. Bretton Woods was a rule-based monetary system whose relatively recent demise in international monetary history has been a test-bed for many explanatory schools of thought. But it has been well studied recently. Chapter 5 will instead focus on the consequences of the continuing debates among monetary economists and central bankers regarding the relative merits and problems of rule-based vs. discretionary monetary orders. It applies the constructivist institutional theoretical framework to the distinctions between the rule-based gold standard and the current "discretionary" system of competitive floating exchange rates. The comparative deontic powers of central banks are developed in each system.

In my analysis, rule-following behavior in both systems is found to be discretionary and contingent. The "rules of the game" of the classical

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