The Rule of Law or the Rule of Central Bankers?

Lawrence H. White

Economists often prescribe that countries seeking economic development should embrace the principle of the rule of law. I want to suggest that we listen to our own advice and apply it to our monetary and financial system. The principle of the rule of law could usefully guide us in resolving the extraordinary situation we have been in for the past two years or so, and even more importantly help us to avoid future crises.

The approach of Federal Reserve and Treasury officials during this crisis, unfortunately, has been to consider every possible remedy but applying the rule of law.

In case you think I exaggerate, let me quote Ben Bernanke. At a strategy meeting with other Fed and Treasury officials early in the crisis he declared, as reported by the *New York Times*: "There are no atheists in foxholes and no ideologues in financial crises" (Baker 2008). Over at the U.S. Treasury, when Neel Kashkari, the Treasury's chief bailout administrator under Secretary Hank Paulson, was asked by a reporter how the Treasury would spend the $700 billion in bailout money that Congress had provided (essentially without instructions), Kashkari replied that nothing was ruled out. To quote a news account: " 'We are looking at everything,' he said. 'We are trying to figure out what will provide the most benefit to the financial system' " (Ellis 2008).

If we unpack Bernanke's and Kashkari's messages, here is what they were saying: "When we in authority declare that it is time to

---

Cato Journal, Vol. 30, No. 3 (Fall 2010).

Lawrence H. White is Mercatus Professor of Economics at George Mason University.

be pragmatic, then we can do whatever we please. There are no durable principles, no constitutional or statutory constraints, limiting what we may do once we declare an emergency. Our hope of avoiding a deeper crisis authorizes us to make it up as we go along, to do whatever seems expedient at any given moment."

Such sentiments are not surprising from men held responsible for the health of the economy—which by the way is an absurd assignment for any government to give, an absurd assignment for anyone to accept, and an absurd assignment for the rest of us to take seriously. Such men understandably want to avoid being seen as doing too little. Had Ben Bernanke stood on principle, he probably would not have been reappointed as Fed chairman by President Obama. (Someone more flexible would likely have taken his place.) What is surprising and disappointing is how many commentators ostensibly in favor of free markets and constitutionally limited government have echoed these sentiments.

The Rule of Law

References to the rule of law are rare in discussions of Federal Reserve policy. The concept of the rule of law in jurisprudence and political philosophy has several dimensions. At its core is the classical liberal principle of nondiscretionary governance that stands in contrast to the arbitrary or discretionary rule of those people currently in authority. In shorthand, either we have the rule of law or we have the rule of authorities. Under the rule of law, government agencies do nothing but faithfully enforce statutes already on the books. Under the rule of authorities, those in positions of executive authority have the discretion to make up substantive new decrees as they go along, and to forego enforcing the statutes on the books.

Friedrich Hayek in his classic work *The Road to Serfdom* contrasted "a country under arbitrary government" from a free country that observes "the great principle known as the Rule of Law." "Stripped of all technicalities," he continued, "this means that government in all its actions is bound by rules fixed and announced beforehand—rules which make it possible to foresee with fair certainty how the authority will use its coercive powers in given circumstances and to plan one's individual affairs on the basis of this knowledge" (Hayek [1944] 2007: 112).

It is of course true that laws must be executed by people in authority. We also know that the referees in a soccer match will be people (although robot referees would be cool). But they can either be people who impartially enforce the rules of the sport as they were known at the outset of the match—that is, who follow the rule of law—or they can be people who arbitrarily enforce rules against one team but not the other, or (even worse) who penalize a team for "infractions" of novel "rules" that they have made up in mid-match.

The rule of law concept has deep historical roots. Hayek elsewhere (1969: 118) quotes David Hume's *History of England*—written two centuries earlier—on the value of establishing the rule of law in place of the unconstrained discretion of government officials. Hume acknowledges that it is not always convenient in the short run to forego ad hoc measures. He writes that "some inconveniences arise from the maxim of adhering strictly to law," but affirms the lesson of history that in the long run we are better off from adhering to the rule of law. According to Hume, "It has been found, that . . . the advantages so much overbalance" the inconveniences that we should salute our ancestors who established the principle.

The contrast between the rule of law and the rule of men is sometimes traced still further back to Plato's dialogue entitled *Laws*. In that work (¶ 715d), the Athenian Stranger declares that a city will enjoy safety and other benefits of the gods where the law "is despot over the rulers, and the rulers are slaves of the law." In other words, government officials are to be the servants and not the masters of society.

The rule of law is vitally important because it allows a society to combine freedom, justice, and a thriving economic order (see Barnett 1998). When legal rules are known and government actions are predictable, free people can confidently plan their lives and businesses, and can coordinate their plans with one another through the market economy. Citizens need not fear arbitrary confiscation of their possessions or nullification of their contracts. Entrepreneurs know that if they succeed in turning lower-valued bundles of inputs into higher-valued products, they get to keep the rewards. If they fail, they fail, and they bear the losses.

The Rule of Central Bankers

What does all this have to do with avoiding and resolving financial crises? The rule of law clearly does *not* prevail in our current monetary and financial systems. We do not have, to use Hayek's words, "government in all its actions . . . bound by rules fixed and announced beforehand." Not when participants in financial markets hang on every word from the lips of the central banker, trying to guess his future policy actions.

Central bankers today are discretionary rulers over the economy's monetary and financial institutions. Defenders of the rule of law, who in general decry the arbitrary rule of men, should specifically decry the rule of central bankers. Central bankers today are not "slaves of the law" but exercise wide discretion in monetary policy and regulatory rule-making under the legislation that created and empowered the central bank.

Discretion in monetary policy and financial regulatory policy does not give us better results. It is today widely recognized that inflation is inadvertently fostered by the discretionary policies of central banks, where "discretion" means the absence of pre-commitment to any fixed policy rule (see Kydland and Prescott 1977). It should also be widely recognized that discretionary central bank policy can create asset price bubbles, as the record since 2001 has shown. I need not recite the evidence that the Federal Reserve inflated the housing bubble that preceded the crash. But I do want to note that when Alan Greenspan held interest rates so low that the real fed funds rate (the nominal rate minus the contemporary inflation rate) was negative for two and a half years, he was exercising discretion, not faithfully executing any rule on the books.

Just as inflating central bankers like to pose as inflation fighters, they also like to pose as stabilizers of financial markets. Indeed, they responded to the instability in the aftermath of the bubble's collapse in a highly discretionary fashion. In their policies for addressing the current crisis, central bankers have not limited themselves to the orthodox crisis policies of injecting reserves into the banking system in the aggregate and making short-term last-resort loans to particularly illiquid commercial banks, policies that are already disturbingly discretionary. They and Treasury ministers have been unorthodox and undeniably arbitrary, bestowing favors on some firms and burdens on others. The Bernanke Fed—and normally one shouldn't personalize the Fed, but here the topic is actions that exemplify the rule of men in authority rather than the rule of law—has by its arbitrariness violated the rule of law in at least the following actions:

1. The Fed created new “facilities” for lending to nonbanks and for buying their illiquid or toxic assets, even dedicating the majority of the Fed’s asset portfolio to these facilities.
2. The Fed set up a special subsidiary (called “Maiden Lane LLC”) to sweeten an acquisition deal to protect the bondholders of the investment house Bear Stearns. It did not do the same for the investment house Lehman Brothers. It set up other subsidiaries (Maiden Lane II, Maiden Lane III) to buy and hold bad assets from a single failed insurance company, AIG.
3. The Fed jammed the failed investment house Merrill Lynch down the throat of Bank of America. The Fed had decided that Merrill Lynch needed to be immediately acquired rather than liquidated. The Bank of America’s CEO Ken Lewis initially agreed that BOA would be the acquirer, then changed his mind when due diligence revealed that Merrill’s assets were more toxic than previously suspected. Rather than let BOA back out, as the potential acquirer has every right to do in such a case, Paulson and Bernanke reportedly “pressured Lewis into violating his own legal fiduciary duty to his shareholders, who had to approve the deal based on accurate information. Relying on no legal authority whatsoever, the Fed and Treasury threatened to remove the board and management of Bank of America if they refused to go forward and demanded that Lewis not divulge the conversation” (Kuttner 2009).

As Hayek ([1944] 2007: 115) warned in *The Road to Serfdom*, giving an executive agency (or legislature) the discretion to bestow benefits and burdens on known recipients is a recipe for partiality:

> Where the precise effects of government policy on particular people are known, where the government aims directly at such particular effects, it cannot help knowing these effects, and therefore cannot be impartial. It must, of necessity, take sides, imposing its valuations upon people and, instead of assisting them in the advancement of their own ends, choose the ends for them.

If we expand our discussion to include the Paulson-Geithner Treasury, we could note its forcing an arbitrary set of nine major banks to issue and sell new preferred shares to the Treasury. Some banks wanted to make the deal, but others did not. Three of the banks were newly converted investment houses, given commercial bank status with unprecedented speed, just in time to qualify for the infusion. The same treatment was later extended to smaller banks.

There is a serious question as to whether all of the Fed's actions have even been technically legal under the Federal Reserve Act. The Federal Reserve's statutory authority is overly broad, but even so may not be broad enough to cover all of the Fed's nontraditional actions in the crisis. Experts like Walker Todd, formerly an attorney on the staffs of the Federal Reserve Banks of New York and Cleveland, now a fellow of the American Institute of Economic Research, are skeptical. Todd (2008) has dryly commented that "much less of [the Fed's recent] lending is based on clear statutory authority than one might prefer if one cared about the rule of law and the potential for tyrannical government." Since the spring of 2008, the Fed in its press releases has repeatedly claimed authority under the emergency provisions of section 13(3) of the Federal Reserve Act.[1] The current language of the section authorizes the Fed's Board of Governors, "in unusual and exigent circumstances," which prevail "during such periods as the said board may determine" by a vote, to "discount . . . notes, drafts, and bills of exchange" for any individuals or firms it chooses (not just for commercial banks). The Fed interprets 13(3) as essentially giving it carte blanche. One has to read between the lines and off the edge of the page, however, to find authority for the Fed to purchase assets that are not "notes, drafts, and bills of exchange," or authority to create special subsidiaries to do so. It is difficult to disagree with economist Edward Kane when he states bluntly that the Fed in the last 18 months "has exercised discretion it was never given" (Bergman n.d.).

Whatever the extent of its statutory authority, the Fed violates the rule of law by its repeated use of 13(3). Under the cover of emergency, the Fed undertakes essentially fiscal operations of

[1]For the text of the Act, see www.federalreserve.gov/aboutthefed/section13.htm. For its citation as authority for the creation of the Maiden Lane LLC's and such, see the footnotes to the Fed's latest statement of "Factors Affecting Reserve Balances" (www.federalreserve.gov/releases/h41/current). On the 1991 amendments, see Todd (1993).

subsidizing certain classes of firms at taxpayer expense. As Todd notes, "This stands the entire Federal Reserve Act on its head. The exceptional rule—the emergency power—has now become the regular way of doing things and the quantitatively dominant method of extending credit for the Fed" (Bergman n.d.).

If the statute law allows the central bank an indefinitely wide range of actions, practically without constraint, then we have not the rule of law but the rule of central bankers. Hayek ([1944] 2007: 119) explained the difference in *The Road to Serfdom*:

> The fact that someone has full legal authority to act in the way he does gives no answer to the question whether the law gives him power to act arbitrarily or whether the law prescribes unequivocally how he has to act. . . . If the law says that such a board or authority may do what it pleases, anything that board or authority does is legal—but its actions are certainly not subject to the Rule of Law. By giving the government unlimited powers, the most arbitrary rule can be made legal; and in this way a democracy may set up the most complete despotism imaginable.

Following the Rule of Law in a Financial Crisis

What is the alternative? What does the rule of law tell monetary and regulatory authorities to do when large financial firms are insolvent? The first thing it says is: Do *not* practice discretionary forbearance, turning a blind eye in the vain hope that a failing firm's red ink will happily turn to black, that a zombie institution will come back to life, that toxic assets will detoxify themselves. Do not arbitrarily rescue or bail out an insolvent firm at taxpayer expense. Instead, *resolve* the insolvency. If nobody wants to buy the firm as a going concern without subsidy, follow bankruptcy law. If a special bankruptcy law applies to financial institutions, follow that. In the United States, the FDIC Improvement Act of 1991 mandates that the FDIC (Federal Deposit Insurance Corporation) resolve banks on the edge of insolvency swiftly and at least cost to taxpayers. The authorities have been ignoring this statutory mandate. (Instead, the Treasury "injected capital" into failing banks when it forcibly purchased preferred shares.)

Enacting a "prepackaged bankruptcy" law to swiftly resolve future failures of nonbank financial institutions would be a good idea, but in its absence follow the laws that are on the books.

The rule of law in bankruptcy means not only making shareholders accept that they have been wiped out, but also consistently making creditors and counterparty institutions take the losses that are theirs. Creditors divide up the remaining assets without discretionary authorities sheltering them from losses with taxpayer funds.

It is true that putting Lehman Brothers into resolution was a great shock to the financial market, after expectations of a rescue had been established by the Bear Stearns precedent. But an economist must ask: What was the alternative? The alternative to leaving the losses with Lehman's stakeholders was shifting the losses onto taxpayers. This implies either (a) loss-covering handouts to those who deliberately took great risks of loss to enjoy the upside of great gains, or (b) nationalization. Viewed in a long-run perspective, rather than in the heat of the moment, both are worse than resolving major financial institutions that have reached insolvency. Both are inconsistent with the rule of law, because they cannot possibly be applied consistently. Not every failed business in a country can be bailed out and kept on life support indefinitely—there is not enough money in the Treasury. Not every firm can be nationalized—the economy will cease to function.

Consistently enforcing the rules that require insolvent firms to exit the market promptly would remove the kind of uncertainty that followed the Lehman collapse and provide greater clarity to financial markets. It was inconsistency on this front—from abrogation of the rule of law in the Bear Stearns case—that created the situation where the authorities faced the choice between an ugly Lehman failure and the even uglier options of nationalization or open-ended bailouts.

The prospect of bailouts and other favors, in violation of the rule of law, creates moral hazard. We have learned the hard way that letting only shareholders bear losses, while protecting creditor and counterparties at taxpayer expense, as was done in the case of Bear Stearns, is not enough to control moral hazard. After Bear Stearns was rescued, Lehman Brothers *increased* its leverage and its exposure to risky mortgage assets. If creditors and counterparties think that they can count on government protection, they will be willing to lend copiously and cheaply, enabling a borrowing firm like Lehman to hold a highly leveraged portfolio of risky assets. From the viewpoint of the shareholders in an intermediary, the higher return on capital from "leveraging up"—relying heavily on borrowed funds—makes it a profitable strategy when lenders supply funds with very low risk premia. From the viewpoint of the taxpayers now on the hook, the firm takes on an overly leveraged portfolio of overly risky assets. The most stunning examples of this over-leveraging phenomenon were Fannie Mae and Freddie Mac, but investment houses like Lehman and Bear Stearns exhibited it as well.

If everyone knows that the rule of law will be followed, such that nobody will get bailed out, the incentive for imprudence disappears along with the hook into taxpayers. This does not mean that no financial firm will ever act imprudently, but rather that there won't be system-wide malincentives producing an epidemic of imprudence. If it is known that nobody is "too big to fail," or too well connected to fail, then lenders will not let financial firms leverage up cheaply in the belief that they will be protected. The potential for failure of a hedge fund, investment bank, or other financial institution is therefore no rationale for new legal restrictions on them, like arbitrary limits on firm size or imposed capital ratios or executive compensation ceilings. Without the malincentives of implicit or explicit guarantees, their shareholders and those who lend to them can and will appropriately determine how much capital is adequate.

It cannot be denied that with consistent resolution of insolvent firms, in Hume's words, "some inconveniences arise." But the advantages "much overbalance" the inconveniences, for the good reason that pulling the plug on failed firms is consistent with the logic of the market economy—those who stand to gain when they succeed must also stand to lose when they fail. Nationalization and bailouts are failed policies, for the good reasons that they are inconsistent with the logic of a market economy.

Can There Be a Central Bank Consistent with the Rule of Law?

Yes, if the central bank is limited to the useful functions of serving as bankers' banks for clearing and settlement and enforcing known rules regarding the solvency and liquidity of member banks. Such a central bank can be private, as these roles were originally played in historical banking systems by private clearinghouse associations, self-governing membership clubs of banks (Timberlake 1984). Even when clearinghouse associations organized "last-resort" mutual-support lending among member banks the problem of arbitrary government did not arise, because they were not the creatures of legislation. Taxpayers were not on the hook.

Clearinghouse associations did not monopolize the issue of currency nor pursue a monetary policy in pursuit of macroeconomic goals. (A gold or silver standard controlled the quantity of money without the need for a monetary policy.) No one has yet devised a plan for making these last two functions, and thus government central banks as we know them today, compatible with the rule of law.

Many economists favor "independence" for central bankers over monetary policy dictated by the legislature. Congressional backseat-driving of discretionary monetary policy is indeed not an attractive prospect. But those are not the only two alternatives. The rule of law in monetary institutions is served neither by following the legislature's discretion nor the central bankers' discretion.

The independence of Federal Reserve policy in 2001–07, as already noted, did not deliver stability but fueled an unsustainable path in mortgage volumes and housing prices. The key to stability is not the independence but the *restraint* of central bank money and credit creation. Because the incentives facing central bankers do not produce self-restraint, external restraint is needed.

Alternatives to Discretionary Central Banking

Suppose we take fiat money as a given. Milton Friedman long called for a "quantity rule" reform that would replace the central bank's discretion in monetary policy with a nondiscretionary algorithm for money growth (for example: every day expand the monetary base such that M2 grows at 4 percent per year). He sometimes described his proposal as one to replace the central bank's monetary policy committee with a robot. Another quantitative type of rule, Hayek's proposal of 1931, would direct the central bank to target nominal national income (GDP).

After more than 20 years of seeing his advice ignored, Friedman in the early 1980s began to realize that the Fed would not adopt such a proposal because it had no incentive to tie its own hands. Central bankers sincerely believe, despite Friedman's and other evidence, that they can achieve net benefits by their wise use of discretionary powers. For the same reason, Friedman warned, central bankers appointed to carry out an "automatic" monetary policy would find every pretext for reestablishing their discretion. To eliminate the problem they must be sent home completely. In 1984 Friedman proposed abolishing the Federal Open Market Committee, freezing the stock of Fed liabilities (fiat dollars), and allowing commercial banks to again issue banknotes in order to satisfy any growth in the demand to hold currency (Friedman 1982, 1984). Freezing the stock of fiat money is a way of eliminating discretion in monetary policy that it relatively easy to monitor and enforce.

Friedrich Hayek in 1976 began calling for the "denationalization of money." He imagined unbacked or fiat-type banknotes and deposits provided by competing private issuers. Moving money-issue to the private sector, at least in countries where contract law is honored, removes it from the realm of state action where we must worry about holding the money-issuer to the rule of law.

If we are willing to think beyond fiat money, there is much to be said for the system favored by classical liberals from Adam Smith to Ludwig von Mises, free banking on a gold or silver standard. Free banking allows us to implement the ultimate restraint on central banking—namely, doing without a central bank. In a nutshell, gold or silver redeemability for banknotes and deposits in a competitive banking system sets a strict limit on the volume of money and credit created. It imposes a rule on money-issuers by private contract and competition rather than by legislation. A gold or silver standard, without a government central bank to loosen its constraints, will stop the banking system from following a path that inflates a bubble in asset prices.[2]

Proposals for doing without a national central bank are certainly not "radical" in areas that already operate without a central bank, such as Panama (which has official dollarization) and Hong Kong and Estonia (which have a currency board). For a small open economy, tying itself to an external monetary standard through dollarization or a currency board provides a discipline analogous to a gold standard. These arrangements are compatible with the rule of law if they are "orthodox," that is, set up so as to be immune to discretionary tinkering. Their chief drawback today is that they require relying on the

[2]For details on free banking, see Selgin (1996) and White (1999).

good behavior of the external central bank whose currency provides the standard.

Hayek was not always so clear, before 1976, on the benefits of free banking over central banking.[3] During a lecture tour promoting *The Road to Serfdom* in 1945, pointedly cross-examined by two academics on a radio program, Hayek (1994: 116) said that the creation of the Federal Reserve System was *not* a step along the "road to serfdom," and added: "That the monetary system must be under central control has never, to my mind, been denied by any sensible person." Hayek was certainly wrong on the second claim, if we may count Adam Smith and his own mentor Ludwig von Mises as sensible persons. The sequence of Federal Reserve actions over the past two years—including interventions like the Fed's recently announced intention to "subject executives, traders, deal makers and other employees of the biggest banks to regulatory scrutiny of their compensation" (Labaton 2009)[4]—should give us pause that he may have been wrong on the first claim. Perhaps the Federal Reserve System, developing ever more intrusive controls on banking and finance, is now moving us away from freedom and along the road to serfdom.

References

Baker, P. (2008) "A Professor and a Banker Bury Old Dogma on Markets." *New York Times* (20 September).

Barnett, R. (1998) *The Structure of Liberty: Justice and the Rule of Law.* Oxford: Clarendon Press.

Bergman, B. (n.d.) "How the Federal Reserve Contributes to Crises: Interview with Ed Kane, Martin Mayer, and Walker Todd." Available at www.globalresearch.ca/index.php?context=va&aid=15094.

Ellis, D. (2008) "Kashkari: Bank Bailout Just Beginning." CNNMoney.com (7 November). Available at http://money.cnn.com/2008/11/07/news/companies/kashkari_tarp/index.htm?postversion=2008110715.

Epstein, R. (2009) "Executive Compensation Follies." Forbes.com (27 October). Available at www.forbes.com/2009/10/26/

[3]Hayek's mentor Ludwig von Mises, by contrast, was quite clear (see von Mises 1980).

[4]For a critique of the Fed's view that it can intervene wisely into bank compensation, see Epstein (2009).

bernanke-feinberg-compensation-opinions-columnists-richard-a-epstein.html.

Friedman, M. (1982) "Monetary Policy: Theory and Practice." *Journal of Money, Credit, and Banking* 14 (February): 98–118.

______________ (1984) "Monetary Policy for the 1980s." In J. H. Moore (ed.) *To Promote Prosperity,* 23–60. Stanford, Calif.: Hoover Institution.

Hayek, F. A. ([1944] 2007) *The Road to Serfdom.* The Definitive Edition. Vol. 2 of *The Collected Works of F. A. Hayek.* Edited by B. Caldwell. Chicago: University of Chicago Press.

______________ (1969) *Studies in Philosophy, Politics and Economics.* New York: Simon and Schuster.

______________ (1994) *Hayek on Hayek: An Autobiographical Dialogue.* Edited by S. Kresge and L. Wenar. Chicago: University of Chicago Press.

Kuttner, R. (2009) "Betting the Fed." *The American Prospect* (1 June). Available at www.prospect.org/cs/articles?article=betting_the_fed.

Kydland, F. E., and Prescott, E. C. (1977) "Rules Rather than Discretion: The Inconsistency of Optimal Plans." *Journal of Political Economy* 85 (June): 473–91.

Labaton, S. (2009) "Fed Plans to Vet Banker Pay to Discourage Risky Practices." *New York Times* (22 October).

Selgin, G. A. (1996) *Bank Deregulation and Monetary Reform.* London: Routledge.

Timberlake, R. H. Jr. (1984) "The Central Banking Roles of Clearinghouse Associations." *Journal of Money, Credit, and Banking* 16 (February): 1–15.

Todd, W. F. (1993) "FDICIA's Emergency Liquidity Provisions." Federal Reserve Bank of Cleveland *Economic Review* (Fall): 16–23.

______________ (2008) "The Tyrrany of the Fed." American Institute for Economic Research Commentaries (3 April). Available at www.aier.org/research/commentaries/167-the-tyranny-of-the-fed.

von Mises, L. (1980) *The Theory of Money and Credit.* Indianapolis: Liberty Press.

White, L. H. (1999) *The Theory of Monetary Institutions.* Oxford: Blackwell.