



BANK OF ENGLAND

Speech

Central bank independence as a prerequisite for financial stability

Speech given by

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The views expressed are my own and do not necessarily reflect those of the Bank of England or other members of the Financial Policy Committee.

Good evening. Thank you very much Vice Dean for your kind introduction. You may not recall this, but eighteen years ago a young economist produced a research paper titled, 'The Political Economy of Finance'. Paolo, your analysis then that economic growth is dependent upon understanding effective financial regulation was prescient and is as relevant now as it was then.

A critical development since that time is that it is now accepted wisdom that central bank independence in the area of monetary policy has been of significant value. In the UK, the independent Bank of England Monetary Policy Committee (MPC), which underpins the stable monetary policy we presently enjoy, has had a distinguished 22 year history. Moreover, central bank independence is a concept which has widespread global adherence; it is the foundation of monetary stability in Europe, the US, and elsewhere. Given interconnected capital markets and spill-over effects, this has undoubtedly contributed substantially to global monetary stability.

In contrast, central bank independence in the area of financial stability has a much shorter history, and the acceptance of it as settled best practice is less well acknowledged and hence it can be more vulnerable to challenge. In developing this system of macroprudential management, the UK has been at the forefront of addressing the need to underpin national financial stability by reinforcing central bank authority. The specific architecture we have arrived at has emerged as a direct response to the failures of the prior structures. These were catastrophically revealed by the 2008 financial crisis. The UK's response has been to establish a powerful Financial Policy Committee (FPC) within the Bank of England. This policy committee is tasked with the primary remit of delivering financial stability and has been granted the tools necessary to get the job done. The FPC is unequivocally accountable for maintaining national financial stability. It has no other objective which subordinates or compromises this focus.

As a practical matter and as a deliberate design feature, the FPC as a policy committee of the Bank of England is co-located together with the Prudential Regulation Committee (the microprudential regulator) and the MPC. Moreover, through the executives of the Bank, the policy committees enjoy overlapping membership. Importantly, each committee is chaired by the Governor. The effect is to ensure effective communication between the policy committees.

However, although the architecture is proving robust and effective, it is important that the value of maintaining central bank independence with respect to financial stability be reaffirmed. As the memory of the financial crisis recedes, and as strained economic conditions globally challenge relationships between central bankers and politicians, I wish to explain tonight why the present structure we have arrived at remains fit for purpose and is not only effective, but optimal.

I. Central bank independence is under attack

It is evident that one of the most powerful forces shaping the current political climate leading to these emerging strains between politicians and central bankers in other countries is the knock-on effect of populism, in the context of unsatisfied economic expectations. By its nature populism is anti-elitist and it is increasingly anti-establishment. We can debate many things about the character, architecture and effectiveness of the Bank of England but it would be hard to argue that it isn't a central part of the UK establishment. Worse than that, from a populist's perspective, it is technocratic. The Bank is more powerful than it has ever been, and can be perceived as undemocratic as none of the members of its powerful policy committees is subject to election.

We have seen that many central bankers, for example in the US, India, Turkey, Frankfurt, etc. have been subject to political pressure. These pressures challenge central bank authority and autonomy. This raises the question of the importance of articulating the legitimacy of how the Bank of England operates independently of our democratically accountable government.

For my part, I may be characterised by some as one of the technocrats. If so, I'm an unusual technocrat. I'm in fact one of the five external members of the 13 person Financial Policy Committee. We, the external members, are specifically positioned on the Committee to ensure that it doesn't become too dominated by internal institutional group think, and we have the opportunity to directly influence decision making with externally obtained experiences and expertise. So, although I am in some sense a technocrat, I like to think that I, like my external member colleagues, aren't unequivocally insiders. Certainly we are not technocrats in a classic sense. However, in my case my objectivity in addressing this issue of Bank of England independence stems not only from my external member identity, but principally because in two weeks' time I will no longer be a member of the FPC. Like each of you, I will be a citizen outside the institution of the Bank of England and subject to it. Hence I believe I can be seen to be addressing this issue of the legitimacy of the Bank of England's independence not only from experience but also with particular objectivity.

This afternoon, my central thesis is twofold: Firstly that the concept that the Bank of England is 'independent' is significantly overstated. Secondly, its independence is operational and that the operational independence which the Bank does enjoy is the critical keystone of our present and future financial stability.

II. Operational independence and accountability

Why is the 'independence' of the Bank overstated?

The Bank has in fact received delegated authority from Parliament and operates within the constraints of laws passed by Parliament. The Bank is transparent and is subject to layers of oversight, for example all members of policy committees are appointed by the Government.

It follows that the independence of the Bank originates from, and is dependent on, the will of Parliament.

The Bank's self-description sets out visibly that it has a dual mandate remit to enhance national welfare by delivering both monetary and financial stability.

The Bank is in practice the people's bank. And it is explicitly committed to engaging with the people of the UK through a myriad of channels. We have set up citizen's panels, where anyone who is interested can apply to attend and feed in directly their views and experiences. Our agents have one-to-one conversations every day with business and community organisations in their area. We communicate through press releases, speeches such as this, publications on our website, social media and so on. In short, we are visibly the people's bank. Rather than hiding away in ivory towers we are connecting with the people of the United Kingdom each and every day.

III. Why independence?

When, over 20 years ago, the Bank was granted the decision-making authority over the tools of monetary policy in a then newly created MPC, it was an unexpected and radical decision. Nevertheless it was a decision which went with the grain of thinking at the time; the Maastricht treaty of 1992, for example, established that the ECB should exercise its monetary policy free from political interference and similarly required that all euro central banks should similarly operate outside of political control as a condition of membership of the single currency. Following the financial instability of the preceding decades it was evident that effective monetary policy required professional objectivity free from the political compromises. The main driver of this consciousness was a broadly global acceptance that there exists time inconsistency between the objectives of politicians - particularly for those subject to electoral cycles - and the needs of policy actions to deliver price stability.¹ As Mark Carney emphasised at the conference marking the 20 years of Bank of England independence, politicians in control of policy decisions are structurally compromised from making the right decisions. He said:

*"Experience teaches that political control of monetary policy decisions suffers from time inconsistency, in which policy makers promise low inflation, then go for faster growth and ultimately achieve neither."*²

It is generally accepted with the benefit of hindsight that this authority vested in the Bank has been a foundation of the financial and economic credibility which the UK enjoys.

Stanley Fischer, the rightly revered and respected authority, whose advice led to the positioning of the FPC within the Bank of England, speaking at the same conference said:

*"...the case for monetary policy independence set out in the 1990s remains sound, and monetary policy independence is now widely accepted in the United Kingdom, as it long has been in the United States."*³

If the issue is settled for monetary policy independence, what of financial policy independence?

¹ See for example: Alesina, and Summers (1993); Cukierman and Neyapti (1992); Berger, Haan, Eijffinger (2001)

² [Opening remarks to the Bank of England 'Independence - 20 years on' Conference](#)

³ <https://www.federalreserve.gov/newsevents/speech/fischer20170928a.htm>

The 2008 financial crisis is assessed to have cost the UK economy over £2 trillion in lost output. The subsequent post-mortem reports and analyses provide clear visibility of some of the political pressures which contributed to the debacle. Lord Turner, who took over the FSA after its failure, which had been charged with the duty of microprudential regulation, testified to the Treasury Select Committee that:

“All the pressure on the FSA was not to say why aren’t you looking at these business models, but why are you being so heavy and intrusive, can’t you make your regulation a bit more light touch?”⁴

And more explicitly he stated:

“There was a philosophy rooted in political assumptions which suggested the key priority was to keep it light rather than to ask more questions.”

Therefore, following the 2008 financial crisis, Parliament endorsed the consensus that an independent body needed to take responsibility for overseeing the stability of the financial system as a whole. The consequent creation of the FPC underpins the credibility the UK enjoys in the global capital markets. Holders of gilts and international investors in the UK must appreciate that the FPC within the Bank of England operates free from the compromises created by the theatre of politics and the electoral cycle. The need to create this space for the financial stability regulator to operate away from the politicians and the Treasury arose out of the commendable self-awareness of the post crisis government and Treasury officials at that time. They fully recognised that time inconsistency leads to dangerously weaker policy formulation and implementation. Parliament endorsed their view. Moreover, Parliament recognised the need for a simple, clear, overriding mandate for financial stability to create precision in accountability and therefore effectiveness.

Following decades of monetary policy independence, studies have empirically demonstrated that time inconsistency compromises policy decision making and implementation.⁵ It is my unequivocal contention that although it is too early to expect such studies to endorse independent financial stability policy, such independence is absolutely valid.

So how is the FPC positioned to be both responsive to the need for uncompromised decision making yet at the same accommodating to the need to operate within the UK’s tradition of democracy and the rule of law? How independent is it?

IV. FPC accountability

The FPC, formally established in April 2013, has been established by an act of Parliament which has granted it powers of direction and powers of general recommendations, as well as the power to make recommendations on a comply or explain basis. It possesses the tools necessary to act.

⁴ <https://publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/144/144i.pdf>

⁵ Leverty and Grace (2018); Liu and Ngo (2014); and Englaier and Stowasser (2017)

We are constituted with membership from the Bank of England, 6 internal members including the Governor and the head of the PRA, 5 external members, the head of the FCA, and a representative member from the Treasury. In contrast to the MPC, we make decisions by consensus.

The FPC operates within a comprehensive accountability framework. We meet quarterly, we follow an established agenda, we publish a Record of our meeting and a Financial Stability Report biannually. The conduct of many of our meetings is formally observed by a Bank of England Court member. We testify about our deliberations in front of the Treasury Select Committee at least twice a year and practically more frequently than that; witness for example, when asked by the Treasury Select Committee, we delivered to them our internal Brexit modelling assumptions and testified to discuss the matter. The Governor and other executive members testify in front of other committees of Parliament. All committee members make speeches explaining policy, which are published on our website, as this has been. A non-voting Treasury member of the FPC participates in our meetings and is consequently able to monitor not merely our decisions but also our deliberations. Moreover the Governor meets with the Chancellor frequently. Annually the Committee receives a remit letter from the Chancellor, and the Governor responds on the Committee's behalf. Although we operate by consensus decision making, each member may call for a vote and is generally entitled to register any disagreement with policy decisions in the Record of our meetings. Subject only to our financial stability objective, each member is obliged to agree to support the policy of the Government of the day, with an overriding duty to make decisions to preserve the financial stability of the UK. The members are governed by the Bank's Code of Conduct and hence have to be free from any undisclosed conflict of interest and refrain from party political activities or suchlike partisan visible support. The Governor and Deputy Governors are appointed by the Government, as are each of the external members, and all members appointments are subject to review by the Treasury Select Committee, which I can tell you from my own experience is a thorough and daunting process.

Notwithstanding the sophisticated and extensive accountability framework, some concern has been voiced.⁶

Some contend that as our actions may have distributive effects, politicians should have more direct control. For example, it can be argued that in addressing the build-up of unsecured consumer credit the FPC may well have limited the availability or the price of borrowing to households in need of finance. It has also been argued that the FPC should confine itself to systemic resilience and not, for example engage in measures which inhibit credit allocation.

I don't agree. The FPC, in promoting financial stability certainly has to maintain systemic resilience, however it is in addition tasked with identifying and preventing, where possible, systemically destabilising events taking place. There may indeed be unintended redistributive effects. Nevertheless, given the significant cost to national welfare from financial instability, it is right that the financial stability priority is uncompromised by short term political considerations. To make that point more clearly, let's consider housing; there is no doubt that the FPC's actions in using its housing tools may unfortunately inhibit some house purchases. However,

⁶ For example see Ed Balls et al. (2016); Paul Tucker (2018)

when we remember that at the root of the financial crisis was housing debt, it should be abundantly clear why we have acted in the way that we have done and why operational independence is essential. Let's not forget that such actions are transparent and subject to continuous government oversight, and that the FPC's efforts to reduce the frequency and severity of crises contributes to preventing future low growth and protecting vulnerable households. In addition, the 'insurance' design of these housing policy tools is specifically intended to limit adverse effects on growth today.⁷

Moreover, we are conscious that there is a cost to excessive conservatism. Indeed, when the FPC was established the Chancellor at the time warned us that in seeking financial stability of the nation, we shouldn't seek the stability of the graveyard. Indeed, this is qualified in the Bank of England Act, which says that the FPC is not "*required or authorised to exercise its functions in a way that would in its opinion be likely to have a significant adverse effect on the capacity of the financial sector to contribute to growth of the UK economy in the medium or long term*". In practice, all our decisions are subject to a rigorous cost benefit analysis. The Committee gets an annual remit letter from the Chancellor and we are at pains after every policy decision to explain as concretely as we can, not just how it will improve financial stability, but what that actually means.

It's inevitable that from time to time policy committees will make mistakes. Facts change and we respond to market developments. As you know, the UK operates with an adversarial political system. Hence, as a practical matter, it is easier for policy committees to adjust or even reverse policy away from the specific political friction within which politicians operate.

Could we do a better job of communicating what the FPC is and communicating why, as the risk manager for the UK economy we are to be trusted? I think I've changed my view on this. Originally I felt that only the policy wonks should be interested in the Policy Committees of the Bank of England and that it was the Bank of England as a whole which should be visible and trusted as a singular institution. Given potential threats to the constrained central bank independence which I fear might emerge, I believe greater clarity supporting the legitimacy of the separate policy committees is merited.

V. Independence allows objectivity

Although we use carefully structured models and rigorous quantitative analysis, that doesn't mean that we can avoid the use of judgement altogether. We not only have to consider proximate risk but also tail risk events, which by definition may involve an extreme uncertainty and extreme costs in the event that they crystallise.

It may be hard for many in the audience in this hall to accept, but I'm afraid economics and finance aren't really sciences. I'm at one with the great and legendary economist Hayek in recognising the presence and danger of Scientism. The saying goes, "*To a hammer everything's a nail*," and although economists love their models, believing that economics is a science creates too great an expectation of infallible predictability or

⁷ For further information see the Governor's letter on the distributional consequences of financial stability policy: <https://www.parliament.uk/documents/commons-committees/treasury/Correspondence/2017-19/Mark-Carney-030918.pdf>

that models should be expected to predict the future perfectly. True Science allows us to use fundamental laws to predict future outcomes; for example Galileo's prediction that objects of different mass will fall at the same rate in a vacuum; but we can't, and shouldn't, expect the smartest economists or experts to be precisely accurate in predicting the future with respect to financial risk.

As Hayek said in his Nobel lecture of 1974:

"It seems to me that this failure of the economists to guide policy more successfully is closely connected with their propensity to imitate as closely as possible the procedures of the brilliantly successful physical sciences – an attempt which in our field may lead to outright error. It is an approach which has come to be described as the "scientistic" attitude...some of the gravest errors of recent economic policy are a direct consequence of this scientistic error."

He further stated:

"This brings me to the crucial issue. Unlike the position that exists in the physical sciences, in economics and other disciplines that deal with essentially complex phenomena, the aspects of the events to be accounted for about which we can get quantitative data are necessarily limited and may not include the important ones. While in the physical sciences it is generally assumed, probably with good reason, that any important factor which determines the observed events will itself be directly observable and measurable, in the study of such complex phenomena as the market, which depend on the actions of many individuals, all the circumstances which will determine the outcome of a process,...will hardly ever be fully known or measurable"

An appreciation, as Hayek had, of the limits to empirical analysis in policy making is the underlying rationale why this task has been delegated to an objective policy committee, so that the subjective element of decision making is not vulnerable to political expediency.

VI. Independence allows complex decision-making

Leaving aside subjectivity for a moment, the empirical work itself is extremely complex and hard to grasp. Whilst models can't be perfect, they are indeed valuable and essential tools in guiding decision-making. I've operated in finance for forty years in fixed income markets, capital markets, investment banking and private equity analysis. I've spent my career examining financial flows and making risk decisions. With that experience even I've found it very hard to get to grips with the complexity of FPC analysis and decision making. We have to look at complex bank capital buffers, risk weightings, counter cyclical analysis, monetary flows, spill-over effects, domestic shock analysis, cyber risk analysis and emerging risk credit indicators, stress testing etc. If you read our Financial Stability Reports carefully, you will get a flavour for how complex the issues we have to address truly are.

To those who might argue that such decision-making should be returned to the politicians, I would say that the logic just isn't there. I've witnessed highly sophisticated politicians on the Treasury Select Committee

struggle with the complexity of the matters at hand. This isn't in any way questioning their aptitude, this is only to observe the stark reality that the empirical work matters and yet politicians, given their day jobs, can't be expected to have the bandwidth or the time to engage with all the issues. The decision to delegate is supported not just by the need for effective decision-making but also to address the complexity of the decision making processes. Further, as the FPC does not have a quantified target, such as an inflation target, set by Parliament, in my view it is more important that our judgments are taken independently of political pressure. As I set out previously, we then justify these publicly, in detail, so they can be tested by the public and Parliament.

VII. An independent FPC is especially needed in the UK

Effective national prudential structures cannot be one size fits all. Different countries have different political traditions and face different macroprudential challenges. Moreover, nations have different economic experiences. Having quoted Hayek, who I suppose hails from one side of the political divide, I might reflect my present civil service codified impartiality by citing Marx, who may, perhaps, have adherents from the other side of the divide - he once wrote:

“Men make their own history, but they do not make it as they please: they do not make it under self- selected circumstances, but under circumstances existing already, given and transmitted from the past.”

Our national past involved a particularly catastrophic financial crisis; we certainly have a duty to learn from our mistakes.

The UK has a unique collection of macro vulnerabilities which effective macroprudential management has to accommodate. Firstly, we have a relatively high household debt of around 85% of GDP, secondly we have an outsized financial sector whose assets are ten times GDP; and thirdly as a deficit country (which is currently running at 5% of GDP) we require foreign investment support to balance our national finances. Leaving aside the first two vulnerabilities, this third vulnerability alone requires an accepted and settled professionalism to the framework of macro prudential policy making not only for the present but also for the future.

As the 2008 financial crisis demonstrated, present vulnerabilities can be hard to assess or can even hide in plain sight. Politicians and practitioners, unavoidably and inherently focussed on the short term, aren't in a position to make the right macroprudential judgements. Maybe that is part of the answer to the famous question asked by the Queen at another London-based higher education institution, *“Why did nobody notice it?”* She received an answer at the Bank of England, where an economist explained that financial crises are like earthquakes and flu: rare and difficult to predict. Her Majesty was reassured that staff at the Bank are there to help prevent the financial system amplifying shock, as it happened in 2008.

VIII. Conclusion

The FPC functions well. I've seen it assess and analyse risks from the banking sector, Scottish referendum, Brexit risk, the Europe crisis, cyber risk, and domestic credit creation. As revealed in my colleague Anil Kashyap's recent speech, debate between members is challenging and we are well supported by the dedicated team within the Bank of England.⁸ We benefit from the coordination between the monetary side of the Bank and the microprudential regulatory side of the Bank, for example, we have joint meetings with the MPC and the PRC. In summary, the FPC functions well, it has been well designed, it is effective and adds to our international financial credibility. I have been privileged to have been a member of the FPC since its formal inception, I compliment its architects and I'm content with the accomplishments during my tenure.

As I leave the Bank of England there are many proximate and distant sources of risk to our financial stability. I won't list those as there will always be such risks - what does concern me is that there should be no move to change the settled structure of the FPC's locus of policy implementation. The independence it enjoys is thoroughly legitimate and circumscribed. It is a thoroughly professional organisation peopled with leadership of the highest quality and as an insider, outsider or an outside insider I'm confident that our financial stability is safe in its hands.

⁸ Anil Kashyap's speech can be found here: [Come with me to the FPC.](#)

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