The Rt Hon Sir Edward George GBE: Central bank independence

Speech by The Rt Hon Sir Edward George GBE, Governor of the Bank of England, to the SEANZA Governors' Symposium in Colombo, Sri Lanka, on 26 August 2000.

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Governor Jayawardena, fellow central bankers, I am honoured, personally and on behalf of the Bank of England to participate in your celebrations.

On behalf of the Bank of England, and, I am sure, of all your guests here this morning, I congratulate you, Mr Governor, on the great contribution that the Central Bank of Sri Lanka has made to the development of your beautiful country in your first fifty years and I wish you continuing success in your task in the years to come.

You invite me to speak about Central Bank Independence, which of course I am happy to do - although I should perhaps make clear at the outset that it is a concept which I find somewhat elusive. Like so many other debates, the debate about central bank independence often seems to become unduly polarised.

At one extreme it seems that some of those who resist central bank independence as undemocratic - or even some central bankers who favour it - assume that it involves an elite body of individuals, who, once appointed are, by virtue of statute, beyond political influence, with extensive but only generally-defined powers to affect the financial environment - and hence the lives of individuals and businesses throughout their currency area. At the opposite extreme it sometimes seems that the only alternative is for the central bank to be simply another arm of government, subservient to finance ministers and their officials.

Now I don't know how many of you would recognise yourselves under either of these extreme categorisations. I guess not very many.

I have to confess that - however attractive this definition of independence might appear as a central banking career option - if this really were the choice to be made, then, as a citizen of a democratic society I would have to choose the non-independent alternative. But, of course, the real debate is much more subtle and extends across a much narrower part of the spectrum between these polar extremes.

The real debate is in fact well described by John Exter, the Federal Reserve Board official, who advised on the establishment of the Central Bank of Ceylon, as it then was, and stayed on to become its first Governor.

In his Report - published in November 1949 - Exter presented a draft bill accompanied by a commentary. It is still well worth reading. In that commentary Exter first outlines the case for the new central bank being "non-political" and having "a considerable amount of independence" - essentially on the grounds that central banking "puts the government into the business life of a country at especially critical points, namely banking and other credit activities, capital markets, foreign exchange markets and the supply of currency", and that it "embraces problems which are of an unusually technical nature"!

But Exter goes on to recognise that "there are many important problems of monetary policy, especially those relating to fiscal policy, on which a central bank must necessarily work in close harmony with the government". Noting that many governments had learned to value the sort of independent and objective, detached, advice that central banks are able to give, Exter nevertheless acknowledges that "on matters of vital interest to the state it would be impossible for a central bank to adopt a policy contrary to the policy of the Government of the day". His killer argument is that no central banker can help but be "acutely conscious of the fact that, since no Parliament can bind its successors, their independence is limited by the ultimate power of the Government to change the law".

He concludes that the exact degree of independence of the central bank is likely to vary from time to time (giving the example of a peacetime and wartime economy) and he describes the ideal as one in which there will be continuous and constructive cooperation between the central bank and the Government. The effectiveness of this cooperation - he says - will depend more upon the men occupying the key positions at particular times than upon any legal formula, no matter how carefully or elaborately it might be worked out.

I have quoted from Exter's Report at some length because of its particular relevance to this anniversary occasion, but also because, although he was writing in the particular context of Sri Lanka at the end of the 1940's, contemplating a move from a currency board to a central bank, much of his comment is timeless. I should like to elaborate upon - or supplement - some of his themes drawing upon our own experience in the United Kingdom.

For just over 50 years - from 1946 to 1998 - the Bank of England operated under legislation which, remarkably, did not attempt to define our objectives or functions - they were simply assumed to carry over from our earlier long history. The 1946 Bank of England Act conferred upon us powers, subject to the agreement of the Chancellor of the Exchequer, to issue directions to bankers - though the term "bankers" was not defined; and it provided for the Treasury to give such directions to the Bank as, after consultation with the Governor, they thought necessary in the public interest. Such directions would necessarily have been made public: none were in fact ever given. In any event the Bank of England was in a formal, statutory, sense throughout this period well along the spectrum towards the subservient polar extreme which I described earlier, in relation to policy making, although we did enjoy elements of independence, for example, in relation to security of tenure for the duration of fixed term appointments for Governors and Directors, and in some degree in relation to our finances.

I am bound to say though that this was not at all how it felt in practice. Even within this statutory framework independence is rather like age - you are as independent as you feel!

The question really came down to how far we were able to influence the Government, which in turn depended upon how far they themselves valued our advice and how far they felt a need to take account of it in the light of possible public - including importantly financial market - reactions in the event of disagreement. Clearly this put the ball very much in our own court in the sense that we needed to do all that we could to persuade successive Governments, but also financial markets and the public at large, of our integrity and objectivity on the one hand and of our technical and analytical competence on the other. Without that our input to policy would not have been worth very much, and would not have carried conviction. In fact integrity and objectivity together with professional competence are in my view the essential foundations of effective independence whatever the statutory framework. Fundamentally it is up to us!

For much of the period after 1946 two contextual factors served in any event to limit the degree of independence we could realistically expect to achieve.

The first was the post-war context of direct intervention and controls, including initially the physical allocation of scarce materials and consumer rationing but extended to the financial system for example through credit ceilings and directional guidance as well as exchange controls, which were only finally removed in 1979. Direct resource allocation rather than allocation through market mechanisms involves intrinsically political judgements - choices between the social value of some forms of activity against others - which cannot easily be devolved to appointed officials. It would put the officials dangerously in the political firing line - calling their impartiality and objectivity into question - if they were. While central banks may legitimately advise on the technical implementation of such intervention, and be the agency through which it is carried out, it is far better all round in my view that responsibility for the choices implicit in such policies remains clearly with the Government.

Secondly, for a long time after the war in the UK - until well into the 1970's, majority opinion did not identify a specific role for monetary policy within overall economic policy; nor was there any very clear understanding of the central bank's role in maintaining systemic financial stability.

Economic policy was widely seen as requiring the use of all available policy instruments - monetary policy, overall fiscal policy, direct controls, as I say, even prices and incomes policies - in concert to

achieve an appropriate balance at any particular time between what were seen as the conflicting objectives of growth and employment, on the one hand, and controlling inflation and maintaining reasonable balance of payments equilibrium, on the other. Economic policy overall was in fact directed at managing what was seen as the trade-off between these social objectives. And this again involved intrinsically political rather than technical judgements, though in this context, too, there clearly was a role for the central bank in proffering detached technical and analytical advice. Also during this period, while it was accepted that the Bank of England exercised prudential supervision over the mainstream banking system, there was no effective oversight of the deposit-taking institutions that grew up outside the area of controls. It was only in 1979, after the fringe banking crisis of the early 1970's, that the Bank was given formal supervisory authority, extending to all deposit-taking institutions, but even then with the specific purpose of providing greater protection to depositors.

Our world changed, gradually but very markedly, from the 1970's onwards in all of these respects. Direct methods of monetary control gave way to fully-fledged market-based techniques, encouraging but also encouraged by intensified financial competition, increasingly driven by the IT revolution. Crucially, a consensus gradually developed - with the Bank's strong encouragement - across a broad political spectrum in the UK (as it had earlier elsewhere) which recognised that there is in reality no trade-off between growth and stability except possibly in the short term. It recognised in fact the nowadays near-universal central bankers' mantra that stability is a necessary condition for sustainable growth. The consensus recognised, too, that, while overall fiscal policy had significant implications for macro-economic stability over the medium and longer-term it was not sufficiently flexible or adaptable to play the primary stabilising role in the shorter term. That task was specifically allocated to monetary policy. Finally, there was an emerging recognition of the potential for conflict between the central bank's necessary concern with systemic financial stability (you cannot hope to deliver monetary stability if the financial system is crashing about your ears, while monetary stability is itself a primary condition for financial stability) and consumer or depositor protection, which if carried too far can itself undermine the strength of the financial system.

These profound changes in underlying philosophy - which, as I say, spread across much of the political spectrum - were in our case fundamentally important in opening the way to a more clearly defined and distinctive role for the Bank of England and a necessary condition, in my view, for the delegation by the Government to the Bank of greater independent, technical, responsibility.

Even so, although those changes were a necessary condition, they were not in themselves sufficient, and greater independence did not come all at once.

As often happens, sadly, a big step forward came after a major setback. In 1992 after we had been driven unceremoniously out of the European Exchange Rate Mechanism (following the boom and bust of the late 1980s / early 1990s), the Government of the day adopted an explicit inflation target as the nominal anchor for monetary policy. Interest rate decisions in pursuit of that target remained with the Chancellor of the Exchequer after consultation with myself as Governor and my senior monetary policy experts at the Bank. But the really novel feature of the new arrangements was their transparency. The Bank was required by the Government to publish a quarterly Inflation Report setting out the background to the monetary policy decisions and the prognosis, and, going further, Chancellor Kenneth Clarke, subsequently decided that minutes of our policymaking meetings should be published six weeks or so after the event.

This degree of transparency was a bold and far-reaching step. Before that - apart from the dozen or so people directly involved in the decision-making process - no one knew with any certainty whether the mistakes that were made were a result of intervention by the Prime Minister, bad decisions by the Chancellor, with or without advice from Treasury officials, or bad advice from the Governor and/or his colleagues at the Bank. We all kept our heads down when things went badly, only putting them above the parapet when things went well. The Bank was, it is true, able within limits to explain its thinking publicly when summoned to appear before the relevant House of Commons Select Committee, or through Governor's speeches, and this possibility may have acted as some kind of a constraint on the Government, but such opportunities needed to be used with discretion or they could have caused a breakdown in the "continuous and constructive cooperation between the central bank

and the Government" which Exter rightly identified as the ideal - I would say even essential - relationship.

I think successive Chancellors came to recognise that the opaqueness of the existing decision-making process was inappropriate in principle in an effective democracy, which requires that we should each be accountable for the decisions that we take or for the advice that we give. They may also have thought that the public generally and Parliament in particular would not put up with it for much longer anyway. Or they may simply have felt that they were no longer prepared to carry the can for the bad advice they received. Whatever the motivation it is to their great credit that they were prepared to put their own reputations - as well as that of the Bank - on the line in this way! It not only allowed the Bank to express its own analysis and judgements about monetary policy publicly, it actually required us to do so. That really concentrated the mind I can tell you; and it provided us with added stimulus to sharpen up our act. But for it to have this effect it was crucial that the intended integrity of the process was respected. What you saw in the minutes of "the Ken and Eddie show" was verbatim the advice which I gave to the Chancellor and which I had discussed with senior colleagues beforehand.

This new transparency was a big step towards greater independence for the Bank. But it was carried much further by Chancellor Gordon Brown, as literally the new Labour Government's first act of policy - just four days after coming into office in 1997 - when he announced that the Bank would henceforth be independently responsible for the operation of monetary policy. This commitment was subsequently embodied in a new Bank of England Act that came into effect in 1998.

The key characteristics of the new legislation were clarity of definition of the Bank's responsibilities, and transparency and elaborate provision for public accountability for the manner in which those responsibilities are carried out.

In relation to monetary policy in particular the new Act defines our responsibility as "to maintain price stability and, subject to that, to support the economic policy of the Government including its objectives for growth and employment". It is the Chancellor who defines what, more precisely, is to be understood by "price stability" which he has done in the form of a symmetrical 2½% target for a particular statistical measure of retail prices. So we have "instrument" rather than "goal" independence.

It is sometimes suggested that this is a second best arrangement. In our national context at least I disagree with that view. The precise objective of policy - even within the confines of the concept of price stability - remains a political decision: there will always be those who argue for a somewhat higher or somewhat lower target, and the fact that the Government endorses a precise target rather than just the vaguer goal of "stability" certainly strengthens our hand by allowing us to concentrate upon our essentially technical task. I am bound to say that in practice it seems to me to be rather a second order issue anyway given the narrowness of the range of definitions of "stability" that would carry conviction with the public, including financial markets.

The Act confers the responsibility for meeting the Government's inflation target specifically on a newly created Monetary Policy Committee, comprising myself as Chairman, the two Deputy Governors, two Executive Directors appointed by the Governor after consultation with the Chancellor and four members appointed from outside the Bank by the Chancellor. The Governors are appointed as members of the Committee for their full five year (renewable) terms; the remaining members are appointed for three year terms which are also renewable. The Committee's policy meetings are also attended by a senior Treasury Official in the capacity of an observer, who may participate in the discussion - essentially to inform the Committee of any relevant aspects of the Government's wider economic policies and explain the Committee's thinking to the Chancellor - but he may not express a view on the monetary policy decision or, of course, vote on that decision.

One can argue endlessly about the precise composition of the Committee, their term of appointment and so on. The key consideration for me is that all nine members need to be genuinely independent, technical experts in the field of monetary policy or a closely related field, not representatives of any particular social or industrial grouping. The objective of policy is appropriately determined by a democratic process; the Committee's job is, as I say, a technical one, which requires relevant technical expertise.

The transparency of the Committee's decision-making process is assured by continuation of the requirements that we should produce our quarterly Inflation Report and publish minutes of our monthly meetings, which we have now chosen to do with just a two week delay. Transparency is further enhanced by a requirement that the minutes should record how each individual member of the Committee voted on the interest rate decision.

As before, it is vital for public confidence in these new arrangements that their intention is not subverted by the evolution of informal conventions - that the integrity of the procedures is respected. In this context we take great pains to ensure that the true nature of the policy debate is reflected in the minutes and that the range of views around our inflation forecast is properly reflected in the Inflation Report. In fact I think we probably tend to err on the side of drawing too much, rather than too little, attention to differences of opinion within the Committee which are often largely a question of nuance. But it is better in my view to err on that side rather than to attempt to submerge the differences. We do not, however, attribute particular views to particular individuals. To do so would invite prepared statements and militate against the inter-active debate which is an outstanding and immensely valuable characteristic of our meetings. It would suppress the kind of "what if" discussion in which the same individual may explore alternative views. No attempt is made to concert the outcome of the policy decision; in fact I go out of my way to discourage any kind of collusion, whether between the internal or external members of the Committee - we are, and must remain, nine independent members, individually accountable for our decisions as to how we vote.

This, of course, means that the Committee is divided as often as not; but although this initially led to public comment to the effect that the Committee did not know what it was doing and could not make up its mind, it is now generally accepted as the natural order of things and helps to underline to the public at large that monetary policy making cannot be a precise science - however much it needs to be informed by all the science available to us. That, in our context, is I think now much easier to understand than a more consensual approach would be, but there was certainly a learning period.

It has been suggested to me that the arrangements I have described somehow diminish the position of the Governor. Well if that's true this Governor at least welcomes it! I am sure that all of you are well aware of how finely balanced monetary policy decisions are at the margin, and that all of you have agonised, just as I have, over the right thing to do and the right time to do it. I find the cross-bearings on those decisions provided by the other Committee members - and they are I remind you all highly qualified experts in their own right - immensely reassuring. If a majority of them argued for a particular decision, that would certainly weigh heavily with me, although - as a matter of personal integrity - I always reserve the right to take a different point of view from that of the majority on those occasions when I am particularly confident of my own judgement. That has not so far happened but it almost certainly will; people should not be unduly surprised.

Finally, in relation to monetary policy, let me say a few words about accountability. In the terms of the new Act the Monetary Policy Committee - apart from its public accountability through the Inflation Report and the minutes of its meetings - is accountable for the adequacy of its procedure to the Non-Executive Members on the Bank of England's Board of Directors, who in turn report to Parliament through the medium of the Bank's Annual Report. We are all accountable to Parliament in the sense that we may be - and regularly are - summoned to appear before the relevant Select Committees of both Upper and Lower Houses. And we are accountable to the Chancellor in that the Chairman of the MPC is required to write him an open letter if the rate of inflation diverges by more than one percent either side of the 2½% target explaining why and what steps we propose to take to bring inflation back within that range and over what time period. Finally, the Treasury has the power to give the Bank directions in respect of monetary policy if they are satisfied that the directions are required in the public interest and by extreme economic circumstances.

Again, some observers have suggested that these elaborate accountability provisions are onerous and constrain the Bank's independence. I take the contrary view, that they are essential to the legitimacy of the arrangements as a whole and so actually reinforce our independence - provided of course we are able to provide convincing explanations of our conduct! And the likely public and financial market

reaction is, in my view, the most effective protection against abuse of the Treasury's emergency powers.

What I have described up to this point relates solely to monetary policy. But the new legislation similarly deals with the Bank's other key responsibility - maintaining financial stability. And at the risk of trying your patience let me say a few words about that. Less than a fortnight after announcing the Bank's new independent responsibility for the operation of monetary policy, Chancellor Gordon Brown announced that the Bank's responsibility for banking supervision would pass to a new institution - the Financial Services Authority, or FSA - which would assume responsibility for the regulation and supervision of all financial institutions in the UK. This was widely seen as the price we had to pay for our enhanced monetary policy role. But at the same time the Chancellor confirmed the Bank's continuing responsibility for the stability of the financial system as a whole, so that in fact what this has done - as in relation to monetary policy - is to distinguish and clarify the respective roles: of the Bank, which now focuses upon systemic risk - and retains its lender of last resort role within parameters that are broadly defined by the legislation; of the FSA which oversees both the prudential and business conduct of all individual financial institutions, including the banks, with the emphasis on consumer protection; and the Treasury, which has ultimate responsibility for both these dimensions. The new arrangements make a good deal of sense in the UK context where traditional distinctions between banks and other types of financial institution have progressively eroded and where there has been a general movement towards greater consumer protection across a much broader front. But at the same time as clarifying our respective responsibilities, and providing in each case for transparency and separate accountability for the way in which they are carried out, the new legislation recognises the vital importance of close coordination between them and establishes a framework for that. It is early days to assess the effectiveness of these arrangements, but my impression is that so far they are working well.

Governor Jayawardena, there are many aspects of our new regime that I have not touched upon - including questions relating to our capital, our revenues, expenditure and allocation of profits and how they are reported and accounted for - which can also affect the degree of independence we enjoy. Perhaps we might explore these together with the other issues in our discussion. But I hope I have said enough to draw a few conclusions.

My starting point had been that central bank independence in the extreme sense of exemption from democratic control is unrealistic and inappropriate. Yet wise governments in many countries around the world have recognised that they can gain advantage - in terms of public and market credibility - from detached and unbiased advice in its field of competence from the central bank. The value that they put on the central bank's role depends very much on the quality of that advice - the central bank's objectivity and its technical expertise and professional competence. That is largely down to us. But the benefit a government derives from it depends too upon the advice being seen to be detached and unbiased, as well as technically expert and professionally competent. And that depends also upon the government. It can discourage the central bank from expressing views in public but gain little in terms of credibility from doing so; it can to varying degrees encourage greater independence on the basis that this would strengthen public confidence but accepting that it could involve a greater degree of constraint on its policies; or, where there exists a sufficient consensus on the particular role of monetary and financial policy, it can devolve operational responsibilities to the central bank, holding it publicly accountable for the way in which it exercises those responsibilities but accepting the limitation that such arrangements place on the government's own operational discretion.

There is no single model to fit all situations. The appropriate arrangements for a particular country at any particular time depend upon the economic and financial environment and upon political perceptions relating to the approach to monetary and financial policy. I believe that we are now well served in the case of the UK by the present arrangements involving operational independence, based upon the principles of clearly defined responsibilities, transparency and accountability, which I have described. But I am very conscious that, whatever the formal arrangements applying to the central bank, the political and public confidence on which our position depends is something that we, all of us, need continuously to earn through personal and professional integrity, objectivity and competence. It is in the end, as I say, up to us.