

## Andrew Bailey: Central bank independence – in need of further thinking

Speech by Mr Andrew Bailey, Governor of the Bank of England, at Columbia University, New York City, 14 April 2026.

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Thank you for inviting me to speak today. I am going to use my time to reflect on central bank independence and to point to where I believe the concept is incomplete and hence more challenged. I will use the term CBI hereon.

Modern CBI emerged out of the high inflation era of the 1970s. This does not mean that the concept originated then, it has a much longer history. But in its modern form the 1970s was the experience that prompted change. I will use the Bank of England as a brief case study to illustrate the antecedents to the change.

The first stop is 1802, when Henry Thornton wrote "An Enquiry into the Nature and Effects of the Paper Credit of Great Britain"<sup>1</sup>. Thornton is sometimes described as the father of the modern central bank. He asserted that: "The Bank of England is quite independent of the executive government" (p61). Reconciling this with the extensive lending of the Bank to the Government, he commented that: "The ground on which the bank lends so much to government is clearly that of mutual convenience as well as long habit" (p61). "The preference is no symptom of a want for independence of its directors" (p62). "The government of Great Britain is under little or no temptation either to dictate to the Bank of England, or to lean upon it in any way which is inconvenient or dangerous to the bank itself" (p63). And finally, "To suffer either the solicitation of merchants, or the wishes of government, to determine the measure of the bank issue, is unquestionably to adopt a very false principle of conduct" (p295).

Two points I would draw out from Thornton's description.

First, the older notion of independence relied on what in modern terms we would call an alignment of interests and incentives between government, private interests and the central bank. It did not provide for anything more formal in terms of the form of independence.

Second, it did though require an anchor, and that was the value of money. On this point, let's go back to John Locke writing in the 17<sup>th</sup> century<sup>2</sup>. He emphasised the importance of "money being constantly the same, and by its interest giving the same sort of product, through the whole country" (p35). "Money is the measure of commerce, and of the rate of everything, and therefore ought to be kept as steady and invariable as may be" (p113).

In the wake of the experiences throughout the twentieth century, and particularly after the 1970s, the idea of CBI being assured only by a balance of interests and incentives looked past its time, but the anchoring on the value of money remained as important as ever. Three things followed from this.

First, for many countries, the UK included, CBI evolved to a system of formal statutory powers established in legislation. I do, of course, recognise that some other countries reached this point earlier in the twentieth century.

Second, CBI remained anchored on the stability of the real value of money, achieved through monetary policy.

Third, there are differences between countries in terms of whether monetary policy independence relates to setting the objective, the target, or operating to achieve these two. Broadly speaking, few independent central banks set their own objectives, all are responsible operationally speaking, and the picture is mixed when it comes to setting the target. The UK system is more to the operational end of the distribution in that the Bank of England does not set the objective or the target – it has operational independence.

However, de facto, modern central banks typically have two objectives – monetary and financial stability. The substance of my comments today will be around how these two fit together in the theory and practice of CBI. Given what happened in the 1970s, it is no surprise that modern CBI was based around monetary policy. A core element of the case for CBI in respect of monetary policy is the so-called time consistency argument. Ex ante, a government wants low inflation and stable growth, but ex post it may be tempted to create a little extra inflation to reduce unemployment or ease debt burdens. If people expect this to happen, there is no lasting benefit in terms, say, of lower unemployment, but there is higher inflation, so the worst of both worlds.

Delegating monetary policy to an independent central bank is a commitment device to reduce the incentive to renege on the promise of low inflation, which can thereby anchor inflation expectations. Thus, to take the UK case, an inflation target set by the Government combined with operational CBI to meet that target ensures that the central bank's incentives are aligned with the public interest in price stability.

In principle at least, the argument for financial stability is similar. Governments want a stable financial system, but can be tempted to lower standards to increase lending and growth. So, delegation to an independent central bank makes sense.

Where I think financial stability differs from monetary policy is that the act of delegation is a less robust contract, reflecting the completeness of the remit and the measurability of the objective, and also because of the different direct impact of financial stability on the long-run growth of the economy, a point I will come to later. This opens financial stability up to differences in the way conflicts of interest can arise. Financial stability policies interact with private interests in a variety of ways, so a difference is between monetary policy operating through an aggregate tool and financial stability through many levers directly affecting private interests in many ways. Seen in isolation, each of these levers may not be essential for the financial stability objective, but they are essential when viewed as a set.

For financial stability, there is more scope for conflict between the public good interest and private interests. This can put governments in the position of having to choose

which side to take – to use Thornton's words, between the salutations of merchants and the central bank. The current debate on levels of bank capital is a good illustration of this.

It is striking therefore that the literature has given little attention to the concept of CBI in respect of financial stability. In practice, the issue goes further. Two features of the commentary stand out for me.

The first is a tendency to describe other activities of central banks as tangential to monetary policy. This set of activities includes financial stability.

The second feature goes rather further and suggests that an objective of financial stability can require the central bank to compromise on the objective of monetary stability, particularly when the financial system appears to be under threat of instability. So, this feature moves from tangential to actual conflict of interest.

What then are the consequences of the system we have today? I will pick out two such consequences.

The first consequence is that, to the extent there is tension between the objectives of monetary and financial stability, it can be pro-cyclical. In other words, the relative priority given to financial stability can depend on the conditions at the time. The period before the financial crisis saw a relative neglect of financial stability. The crisis necessarily led to a surge of interest in and emphasis on financial stability. This sort of pro-cyclicality is not, I would argue, the best form of organisation. It needs to be more steady over time in terms of the intensity of focus. This in itself is an argument for robust CBI for financial stability.

The second consequence is that the nature and definition of CBI differs between monetary and financial stability. This is a very important and a, perhaps surprisingly, under-discussed issue. The two notions of CBI – in the context of monetary and financial stability - do differ in important ways.

Why is this the case? Monetary stability is easier to define and certainly easier to capture in a single numerical target – as the UK system does in an inflation target. To be clear, this does not inevitably make the task at hand easier for monetary policy. But it certainly creates a focus. I think it also means that the structure, system and governance of monetary policy is more straightforward to capture in legislation, though not in a way that removes the need for judgement to be exercised by the monetary policymaker.

What is it about financial stability that makes it less straightforward? A number of elements of financial stability are relevant to this question.

First, financial stability is a large canvas and there are many elements to it. This means that not only is it impossible to capture in a single numerical target but it is defined as the absence of something that operates dynamically and across many dimensions and thereby engaging many private interests. It is also the case that determining the line between acceptable risk and the potential for instability is difficult to ground. Success in the world of financial stability comes when nothing happens.

Second, it is important to consider how monetary and financial stability affect the real side of economies. The canonical view of the impact of monetary policy on the long run growth of economies is that if anything it does so only indirectly by preserving price stability and thereby reducing uncertainty so that businesses and households can better plan for the future. An older argument with respect to monetary policy is based on the so-called neutrality of money, such that long-run changes in the money supply affect only nominal variables (prices, wages, exchange rates). They do not affect real variables (real GDP, employment, investment, consumption). The idea goes back to the classical economists, who drew the distinction between the real and nominal spheres of the economy and treated money as a veil over an underlying barter system of exchange. It followed that the monetary policy was assumed not to affect the long-run trend growth rate of economies.

This view has been modified in more recent times. While holding to the view that there is no long-run trade-off between inflation and output, in the short run modern economists tend to treat money as non-neutral because sticky prices and wages mean that changes in money and monetary policy can have a temporary effect on output and employment. Added to this, there is now considerable support for the credit channel effect of monetary policy, working through the supply and cost of credit, not just risk free interest rates.

Financial stability on the other hand has a more immediate and direct effect on the level and growth of real output, employment and investment. For instance, a stable banking system directly supports economic growth, while an unstable one will tend to disrupt lending and have negative consequences for growth. In this sense, there is no long-run trade-off between financial stability and growth either.

This distinction between monetary and financial stability matters in at least two other important respects when thinking about CBI.

First, it follows from the point on growth that financial stability will have clearer distributional effects within the economy and society broadly. This point is important when thinking about CBI, and it can be uncomfortable for central banks (who generally do not wish to be involved in distributional issues).

Second, and closely linked to the distributional point, financial stability will interact with many more areas of public policy. Many other parts of government will state an interest as a consequence because they will consider themselves to be directly affected by the outcomes of decisions taken by central banks in respect of financial stability. In my experience there are many examples of this mechanism at work. It will usually operate most powerfully in other areas of financial and economic policy, but the reach goes further – think of, for instance, policies to do with IT security, cyber risk, etc.

The same goes for private interests. They are more directly engaged by issues of financial stability. This might seem like a strange thing to say. Surely, people have views on interest rates? Of course they do, but in keeping with the more background property of monetary policy – and critical though that is – the private interests are not as sharply defined typically.

The consequence of this difference is that financial stability in its broader sense tends to induce a lot more direct lobbying by affected private interests. It is therefore more talked about in a specific sense, whereas monetary policy is very widely talked about in a more general sense. It means that more interest groups feel that they should have a direct say in financial stability decisions.

Moreover, I would draw a further distinction within financial stability, between macroprudential and microprudential, in other words system-wide and firm specific regulation. The issue is most acute for the latter. If the activity involves directly regulating individual firms, and the objective of that regulation is to get firms to do, or not do, things that had not occurred to them based on their private interest, it is pretty easy to see that the challenge to independence will be more direct and more forceful. And, in my experience, this is exactly what we do see.

Another element relates to an important difference in the process of conducting financial stability policy when compared to monetary policy. Financial stability policy-making often involves setting rules, something which does not arise in the same way for monetary policy (where rules have a different meaning). This can place financial stability work more closely adjacent to the work of governments and parliaments, because as financial stability-focused rules change it will sometimes be necessary for aspects of legislation to change at the same time.

My point is not that this is inevitably problematic, but it creates two phenomena. The first is that the rule-making process drives a regular need for intensive and detailed coordination between central banks' financial stability work and government policy-making. The second is that where the boundary is drawn between central bank financial stability rule-making and what is done by governments and parliaments varies widely across jurisdictions and through time.

So, the conclusion here is that the meaning and substance of CBI is different between monetary policy and financial stability. I am interested that this point is not often made quite so directly.

What are the consequences of this distinction? I can think of times when there has been pressure to avoid compromising monetary policy by placing emphasis on the financial stability sibling. It can also cause approaches towards financial stability to be pro-cyclical, in the sense of only wanting/having to deal with it when times are difficult. There is also a noticeable pro-cyclical nature to the private interests and the lobbying. Thus, as episodes of financial instability recede into the past, the lobbying grows. This can be challenging, because an important part of financial stability policy is counter-cyclical – in other words use the better times to build up the defences. The best statement of this condition came from the economist Hyman Minsky:-

"As a previous financial crisis recedes in time, it is quite natural for central bankers, government officials, bankers, businessmen and even economists to believe that a new era has arrived. Cassandra-like warnings that nothing basic has changed, that there is a financial breaking point that will lead to a deep depression, are naturally ignored in these circumstances." (p237)<sup>3</sup>.

I have used the quotation from Minsky before. After I did so, someone came up to me and said politely, "don't you think it's time to retire Minsky". This intervention illustrated perfectly what Minsky was talking about.

But that leaves the question what to do about all of this? More particularly, we are left with a situation where we have two rather different forms of CBI, or at least sufficiently different to be an issue.

In terms of responses, let me rule out either end of the possible range. I don't think ignoring the difference is acceptable. Nor do I think we can try to override the underlying drivers and make each form the same. That leaves two options I think. One is a form of status quo.

It is to accept that central banks have two objectives – monetary and financial stability – and there are versions of legislated independence attached to both which can differ, and then to say let's limit our ambition to being more transparent in setting out the differences. That would be a step forward, but I am going to argue that we should be more ambitious.

By arguing for ambition, my view is that we should start by identifying what ties the two objectives together rather than what makes them different. Is there a single unifying definition of the objective of central banks which, while not ignoring the differences I have described, seeks to set out the common ground? And, in doing this, is it possible to use this common ground to create a more useful and resilient objective?

The simple answer to whether there is a single unifying definition and objective is yes, and it is I think staring us in the face. It is that the objective of central banks is the value of money, to go back to John Locke.

One way in which I have come to this argument is the experience – highly enjoyable I should say – of visiting schools on my trips around the UK. I usually talk to the Economics and Business students at our equivalent of high schools, and I give a few minutes introduction on the Bank of England and what we do before taking questions. Over the years, I have concluded that the best way to start is by saying that at the Bank we are in the money business, and then describing what I mean by this.

So, what does this mean for an overarching central bank objective, the Value of Money? In some ways, the easy part is monetary policy. The objective of price stability is the stability of the real value of money. Defining financial stability is the harder part. But, can we anchor financial stability in the stability of the nominal value of money? I think that has potential as a definition.

The key element of financial stability is the banking system. Most of the stock of money is on the balance sheets of banks. Fractional reserve banking ties together the money and credit systems. Key here is the assured value of the stock of bank deposits – the stock of commercial bank money (also known as "inside money"). And, for payments, another of the core functions of central banks, the system also depends on the assured nominal value of this inside money. In other words, we trust that a dollar or pound in my

account is worth the same as the dollar or pound in your account. There is, of course, an important anchor to underpin the assured nominal value, namely, the ability to convert inside money into central bank money (outside money).

As Milton Friedman and Anna Schwartz documented, this assured value of inside money was not always true in the history of American banking, where there was an absence of outside money, and the system was unstable.

Beyond providing outside money, as a central bank we regulate banks in good part because we want to ensure trust in money, which means an assured nominal value. This also helps to explain why it tends to be very hard in practice not to assure the nominal value of uninsured bank deposits. It is also why when I look at an innovation such as stablecoins, my reaction is that if you want to be in the payments business in scale, and payments are a key function of money, you have to meet the test of money, and trust in it, which is assured nominal value. It's another talk, so I will not go any further than to say that I think some more work is needed on some stablecoin design to get to this point.

There is though a big question outstanding in my attempt to capture more thoroughly financial stability under the single central bank objective of stability of the value of money. Is the objective of central banks only about money? This is a genuinely open question. It may be that nominally stable money is necessary but not sufficient to ensure that the financial system is able consistently to deliver essential financial services to households and businesses. Definitionally, this would still be a good step forwards however. But, let me set out why I don't think this issue of whether it is only about money is as large as it may seem.

I will start by recognising an important point. Since the financial crisis, the non-bank financial system has expanded in size relative to the bank system. Moreover, if you look at the agenda of the global Financial Stability Board, which I chair, you cannot help notice that it has a very large component of non-bank items, indeed larger than the bank agenda. On the face of it, this looks like a problem for my argument that the central bank financial stability objective can be captured under the value of money.

I'm not sure this is the case. Yes, the non-bank sector has expanded. It reinforces the separation between banks, whose liabilities are money with assured value, and non-banks, whose liabilities are investment type instruments, where the investor should not expect assured value (they take more risk that way, and can earn and lose value).

But, it would be a mistake to believe that we have separated the bank and non-bank systems in a rigid way. We have not. The non-bank system relies on the bank system for liquidity, and in turn the banks are underpinned by central bank liquidity (outside money). The bank and non-bank systems are highly inter-connected but in somewhat different ways to those before the financial crisis. To give an example, banks support non-bank leverage in financial markets via their prime brokerage activities.

So, when central banks look at financial stability in today's world, a lot of our focus is on the interlinkage between the banking and non-banking financial systems. Moreover,

some of this interlinkage is on-balance sheet, some is off-balance sheet but contractual, and some is the potential for contagion in spite of the absence of formal contractual connections.

Another interesting question here is whether the money anchor of a financial stability definition should factor in more explicitly the velocity of as well as value of money. For purely illustrative purposes, let's think in terms of the simple traditional quantity theory of money.  $MV=PY$ , where  $M$  is money supply,  $V$  is the velocity of money,  $P$  is the price level, and  $Y$  is real output. The typical simplifying assumption is that  $V$  and  $Y$  are broadly stable, and thus the price level responds to changes in the money supply.

But what if that is not the case? Let's take the so-called Dash for Cash at the outset of Covid as a very good illustrative case study. There was a precipitous fall in  $Y$  (real output) as economies shut down. At that time, the rate of growth of  $P$  (inflation) was generally very low. There was a so-called Dash for Cash – e.g. firms drew down credit lines with banks out of fear of access as economies entered such a difficult state. In other words, they hoarded money. So, as  $M$  (money supply) rose,  $V$  (velocity) fell very sharply. Let's assume central banks had not stepped in to provide money via QE. There was a risk of a major financial stability problem as the demand for liquidity was not met, and that would have further rebounded onto the state of the economy and monetary policy.

I recognise that this does not provide an answer to whether the QE should have been short-term or more prolonged. That is another question, not for today. But, it does illustrate how there was a strong money anchor to the financial stability question.

A core element of financial stability is that financial institutions which hold money should be trusted, and thus that the value of money can be trusted. Let me illustrate this briefly with a contemporary issue. There is more concern, following recent events, about the resilience of so-called private credit. This is a non-bank activity that has grown rapidly since the financial crisis. The point is sometimes made that private credit – lending to corporates outside the banking system – has grown rapidly because the banks have been over-regulated, and therefore are not so lending. This misses an important point. The main liability of banks is money. We regulate banks to ensure the value of that money. The liability of private credit is not money – it doesn't and shouldn't come with the same assurance of value. That's important to generate lending to support economic activity. The difference is fundamental. The job of financial stability is to ensure that distinction is robust – that is what we have to challenge, test and design in.

I therefore want to leave open the question, can we usefully capture the objectives of central banks - monetary and financial stability – under a single description of the value of money? This needs to have its tyres kicked. But a key part of financial stability is maintaining the integrity of money.

That said, frictions and imperfections in the financial system can lead to sub-optimal outcomes in many states of the world and, notably in bad states when amplification mechanisms can kick in. As with any other type of public policy, there is a role for financial stability policy in mitigating the effects of these frictions. Financial frictions can

however have much broader effects than just via risks to the integrity of money. In theory, at least, that motivates a much broader role for FS policy, particularly with a wider focus on continuity of financial service provision.

It is, however, interesting, and I think remains an open question to consider where are the limits of what an independent central bank should do in the financial stability space. It is then even more incumbent on us to explain what we are doing and why than it is in the more tightly defined monetary policy space.

But, I see merit in creating a single overarching narrative with a strong focus on the value of money. It would remove descriptions of financial stability such as "tangential" or "in conflict". Even more important, it would help to anchor financial stability by emphasising the importance of the value of money. This is important because independence in respect of financial stability is otherwise not as robust, and I would argue not robust enough.

Thank you.

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<sup>1</sup> Henry Thornton, "An Enquiry into the Nature and Effects of the Paper Credit of Great Britain". J. Hatchard, 1802.

<sup>2</sup> John Locke "Economic Writings" London: Rivington, 12<sup>th</sup> Edition, 1824.

<sup>3</sup> Hyman P. Minsky: Stabilizing an Unstable Economy: Yale University Press, 1986.