Seeking Legitimacy

A new settlement for the Bank of England

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Summary of recommendations

Since the global financial crisis of 2007/8, the role of central banks in underpinning and regulating the financial system has been brought into question. The inability to mitigate the large financial crash has resulted in many central banks, including the Bank of England, having financial stability added to their mandates. While this addition is welcome, it has not been accompanied by stronger provisions to keep the Bank's exercise of power democratically accountable. Furthermore, the financial crisis highlighted a broader lack of legitimacy of the Bank's remit and objectives, which remains to be addressed.

The Bank of England is one of the most powerful public economic institutions, so it is vital that it works in the public interest to the best of its ability. We look at several areas that could improve legitimacy, asking the following questions:

How are appointments made to the Bank's most senior positions? How do we ensure that central banks are scrutinised sufficiently by Parliament, with input from experts in academia and civil society?

Can we get the Bank of England to better understand the lived experience of people living and working in the UK economy? How do we get the Bank to work more coherently with the Treasury?

This paper takes no position on the question of a new mandate for the Bank. However, we do look at an area of policy that needs to be addressed for central banks to perform their stabilising role to full effect. Outlined below are starting points for proposals which, if adopted, would set the Bank of England on course for greater legitimacy and accountability.

Area	Proposal
Appointment processes	Alter job descriptions when seeking appointees to the Monetary Policy Committee (MPC) in order to welcome applicants from civil society or trade unions.
	Allow the Treasury Select Committee (TSC) to see a shortlist of candidates and provide feedback to the Chancellor and the Treasury as to where they could promote greater diversity.
	Make the shortlist of applicants for any new Governor public.
Policy hearings in Parliament	Supplement the Inflation Report and Financial Stability Report inquiries (conducted by the TSC) with evidence from a board of independent academics and civil society representatives.
Citizens' Reference Panels	Formalise the process of holding Panels nationwide over extended periods of several months. After a fixed period (e.g. a decade), evidence from the Panels would contribute to a debate in Parliament on the terms of the mandate.
Coordination between HMT and the Bank	Following a crisis, an independent review into monetary policy strategies used or launched during crisis management should take place.
	When interest rates are at the effective lower-bound, enable the MPC to write an open letter to the Chancellor with their expectations or assumptions over fiscal policy.
Credit policy	Install a new unit split across the Bank of England and HMT. The Bank should operate credit guidance instruments as directed by HMT, which in turn receives goals and objectives from the Industrial Strategy set within BEIS.

Introduction

Introduction

During the decade after the 2008 global financial crash, many central banks have been grappling with a profound legitimacy crisis. The *Financial Times* described a 'crisis of confidence' in monetary policymakers in late 2017, escalating to a 'global backlash' a year later.[1] Around a third of experts surveyed by the Centre for Macroeconomics in 2016 stated that the conventional arguments for central bank independence would no longer be relevant over the subsequent 48 months in Western economies.[2]

Building and maintaining public trust is paramount for central banks, for both economic and political reasons.[3] Trust prevents bank runs and inflation scares. At a more fundamental level, it sustains the payments system and keeps the unit of account stable.[4] And it allows central banks to operate free from political interference or disruption. Trust among the public in central banks fell following the crash and, as Figure 1 shows, hardly recovered for the world's two largest central banks: the United States Federal Reserve and the European Central Bank. While data concerning the United Kingdom are more limited, the public appears divided over whether the Bank has an appropriate amount of power and freedom from government.[5] More broadly, trust in institutions and experts seems to have fallen in the UK post financial crisis.[6] This breakdown of the conventional social contract, which assumed the public's trust and consent, is in large part caused by central banks' own flaws. Governments must act to free central banks from the illegitimacy trap.

[1] Giles, C. (2017). 'Central bankers face a crisis of confidence as models fail'. *Financial Times*, October 11. Accessed on 09/04/2019; available at: https://www.ft.com/content/333b3406-acd5-11e7-beba-5521c713abf4 ; Giles, C. and Fleming, S. (2018). 'Global political backlash spreads against central banks'. *Financial Times*, December 9. Accessed on 09/04/2019, available at: https://www.ft.com/content/9534c97e-fa3b-11e8-8b7c-6fa24bd5409c

[2] Centre for Macroeconomics (2016). 'The Future of Central Bank Independence'. December. Accessed on 09/04/2019, available at: http://cfmsurvey.org/surveys/future-central-bank-independence

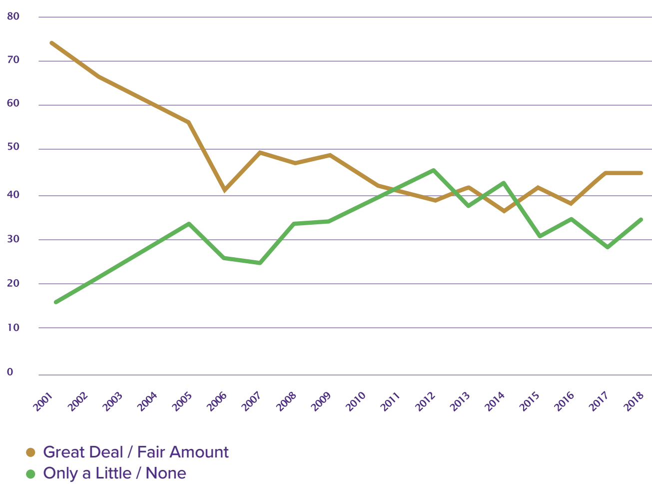
[3] Braun, B. (2016). Speaking to the People? Money, Trust and Central Bank Legitimacy in the Age of Quantitative Easing. MPIfG Discussion Paper 16/12, p. 8

[4] Borio, C. (2019). On money, debt, trust and central banking. BIS Working Papers No. 763, January

[5] YouGov (2012) Bank of England: power balance. Accessed on 18/08/2019, available at: https://yougov.co.uk/topics/politics/articles-reports/2012/09/07/bank-england-power-balance

[6] Edelman Trust Barometer 2019 - UK Results. Accessed on 04/09/2019, available at: https://www.slideshare.net/Edelman_UK/edelman-trust-barometer-2019-uk-results-132908642

Confidence in the Federal Reserve Chair



Trust in European Central Bank, EU Average

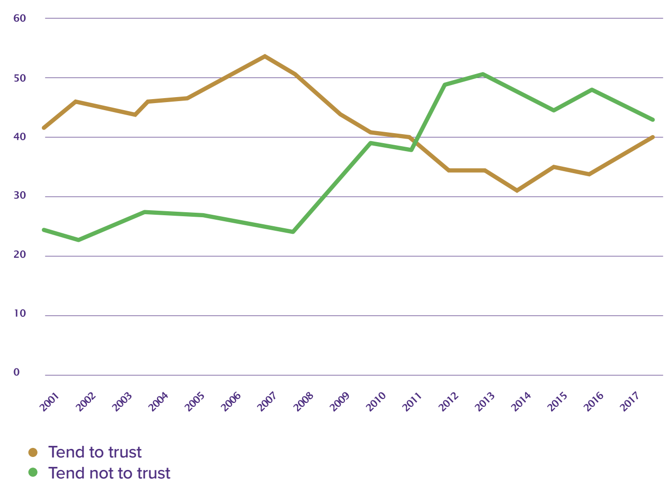


Figure 1: Trust in the world's two largest central banks has declined since before the financial crisis
Source: *Gallup*[7], *Eurobarometer*[8]

Statutory independence for the Bank of England arrived with the 1997 Bank of England Act. The model was inspired by an academic literature claiming strong theoretical and empirical grounds for removing day-to-day operation of monetary policy – setting policy interest rates – from the remit of the Chancellor of the Exchequer. The Bank housed a new Monetary Policy Committee (MPC) which made those decisions on a regular basis, with a view to targeting price stability, as defined by the government. This arrangement is known as' operational independence' (in contrast to 'goal independence', which would allow the Bank to set its own objectives).

The first, and fatal, failing of the conventional model was its inability to prevent the financial crisis in 2007-08. The vast economic cost associated with the crash and subsequent recession caused the legitimacy of the orthodox model to evaporate. Subsequently, the Bank was modified through the Financial Services Act 2012 to incorporate new functions and responsibilities. These included a new mandate of ensuring *financial* stability, and new entities – the Financial Policy Committee and Prudential Regulation Authority – within the Bank to achieve that goal. At the same time monetary policy entered uncharted territory, with the Bank creating £445 billion of new reserves through 'Quantitative Easing' to stimulate economic activity.

[7] Saad, L. (2018). 'Americans Lack Confidence in Key Economic Leaders'. Gallup, April. Accessed on 20/11/2018, available at: https://news.gallup.com/poll/232730/americans-lack-confidence-key-economic-leaders.aspx

[8] European Commission (2019). Eurobarometer. Accessed on 20/11/2018, available at: http://ec.europa.eu/commfrontoffice/publicopinion/index.cfm/Chart/getChart/chartType/gridChart/themeKy/9/groupKy/27/savFile/9

Consequently, the economic orthodoxy underpinning central bank independence collapsed, with drastic consequences for legitimacy.

Several critical assumptions required for orthodox independence to be legitimate now fail. The Bank of England's programme of quantitative easing represents a much more controversial tool to manipulate output and inflation than the conventional lever, the policy interest rate; the effectiveness of both is in question. Moreover, financial stability does not offer a clear goal that can be measured in the same way as price stability, and regulations and incentives used by the Bank are complex and shrouded in confidentiality. Furthermore, the changes in the Financial Services Act have done little to address the Bank's critical blind spot over the sectoral profile of credit in the UK economy. The structure of the money and banking system creates incentives for banks to lend to projects and activities which, in aggregate, have socially harmful effects.

The genie is out of the bottle: central banks are not, and cannot be, truly 'neutral' operators of the macroeconomy and financial system. It is now well understood that choices made (or avoided) by central banks affect the distribution of wealth and income, the prosperity of different sectors, and the degree to which the economy is environmentally sustainable. Thankfully, both the crisis of legitimacy this has generated, and many of the UK's financial and economic problems, can be addressed through a new settlement for the Bank of England.

That begins by recognising that **independence is not black or white but has several dimensions.** Political interference can come in many forms.[9] Reaching a new settlement entails understanding the relationship between the Bank of England and the Treasury, reforming the links between them, and updating the protocols that govern their shared responsibility for the economy. Many of the problems faced by central banks are actually problems of an *inadequate fiscal-monetary framework.*

A new settlement will require understanding both the *purpose* of a modern central bank, the corresponding *functions* it needs to carry out, and the *accountability mechanisms* that ensure the final arrangement enjoys genuine democratic legitimacy. For instance, there is a growing case for central banks to deploy a policy of credit guidance, steering investment towards parts of the economy where the social benefits are greatest.[10] Yet some believe that such policies jeopardise the "very idea of an independent central bank".[11]

Although such concerns don't invalidate the case for reform, they cannot be waved away. Instead, a viable program of reform must also give due consideration to democratic legitimacy and accountability. Where possible, new policies need accountability frameworks to govern their use. As expressed by Annelise Riles, an expert in the legal anthropology of central banks, "certain institutional reforms, and certain new uses of existing institutional levers, can facilitate this important work." [12]

[9] See, for example, the channels discussed in Boettke, P., and Smith, D.J. (2013). Federal Reserve Independence: A Centennial Review. *Journal of Prices & Markets*, Vol. 1, Issue 1, pp. 31-48

[10] van Lerven, F. (2018). Credit Where It's Due: Ten Years After the Lehman Collapse, Finance Still Hasn't Been Fixed. New Economics Foundation, September 14. Accessed on 20/09/2019, available at: https://neweconomics.org/2018/09/take-control-of-credit

[11] Marvin Goodfriend, former chief economist at the Federal Reserve Bank of Richmond, cited in Tucker, P. (2018) *Unelected Power,* p. 482

[12] Riles, A. (2018). *Financial Citizenship*. Cornell University Press. p. 4

The structure of this paper

Chapter 1 offers a starting point for an inquiry into central bank legitimacy. It covers a theoretical overview of the arguments for an independent central bank, as well as noting several features of current policy and economic conditions that represent important departures from that model.

Successive chapters address dimensions of the relationship between the Treasury and the Bank of England. They address improvements to accountability by changing existing measures and mechanisms, as well as some new innovations. Chapter 2 concerns the composition of decision-making committees at the Bank. How appointments to those committees are made is a major factor influencing the accountability of central bankers. The second addresses the issue of dialogue and participation. Expanding and refining channels of communication is central to accountability. Dialogue must not only serve as an operational input to policy; it must also permit reflection on the goals and objectives the Bank is given. The third turns to managing economic crisis, a fundamental aspect of the central bank's role. Yet under such conditions, coordination between the Bank and the Treasury is more crucial than ever. Any institutional framework needs to be able to bend in times of crisis, without jeopardising provisions for accountability.

The final chapter moves further beyond the current framework, outlined by the Bank of England Act, to examine less conventional policies the Bank could adopt. While new policies might be justified on economic grounds, their potential consequences for legitimacy and accountability are less frequently discussed. In particular, there is a case for a new framework for credit guidance, under which the Bank would work in concert with departments of government. A synthesis of this proposal with recommendations made throughout offers some first steps towards a more accountable, and more effective, fiscal-monetary framework.

Chapter 1:

CENTRAL BANKING AT A CROSSWORDS

The orthodox account of central bank independence in its contemporary form emerged in the 1980s. In 1977, Kydland and Prescott introduced the concept of 'time-inconsistency', [13] which highlights how policymakers might choose to renege on previous announcements as to the policy they intend to follow. When applied to monetary policy, the concept implies that elected policymakers are unable to make credible promises to keep inflation at a target level.

When it is in their interests to let the economy run hot – just before an election, say – politicians are expected to renege on any prior promises. When agents in the economy have rational expectations, they will have no faith in authorities to ensure the stability of prices, bringing about inflation in the earlier period, before the election is even in sight. The result is known as 'inflation bias'. Delegation to an independent body allows credible commitment, since the central bankers have no political interest in being lax with price stability in any time period.

[13] Kydland, F. and E. Prescott (1977) 'Rules rather than discretion: The inconsistency of optimal plans', *Journal of Political Economy*, Vol 85, pp. 473-490.

1.1 The breakdown of orthodox independence

Even in the presence of a time inconsistency problem, several further conditions must be met for the orthodox model to hold. Since the central bank's *operational* independence derives legitimacy from both the effectiveness and democratic acceptability of delegating, legitimacy requires that the following assumptions are satisfied:

1. the policy instruments are expected to be effective;
2. the choices being made are not distributional;
3. the goal can be specified; and
4. society's preferences are known and stable.[14]

The financial crisis in 2008 and the subsequent policy response revealed that these assumptions were difficult or impossible to meet in the context of central banking. Critical problems regarding legitimacy therefore arose.

Monetary policy has become ineffective

Powerful trends in the global economy since the new millennium have affected the terms of central bank independence by rendering conventional policy instruments – in short, setting interest rates – much less effective than originally assumed. Reflecting on 'monetary policy in a new era', former Chair of the Federal Reserve Ben Bernanke argued that 'the low-inflation, low-interest-rate environment in which we now live calls into question some of the traditional rationales for central bank independence.'[15] Policy interest rates are likely to be trapped at the 'zero lower-bound' much more often. Even away from the lower bound, surveys suggest that firms' investment decisions are only weakly responsive to interest rate changes.[16]

This recognition that policy rates are a relatively weak tool mean that central banks are increasingly looking to alternative tools, such as large-scale asset purchases and issuing guidance about the expected future path of interest rates ('forward guidance'), to meet their price stability objectives. These tools are extensions of, or lie outside, the intellectual framework for orthodox central bank independence.

[14] Tucker (2018), p. 101. Tucker's account builds on Alesina, A., and Tabellini, G. (2007). 'Bureaucrats or Politicians? Part I: A Single Policy Task'. *The American Economic Review*, Vol. 97, No. 1 (Mar., 2007), pp. 169-179; (2008). 'Bureaucrats or politicians? Part II: Multiple policy tasks'. *Journal of Public Economics*, Vol. 92, No. 3–4, pp. 426-447

[15] Bernanke, B. (2017) Monetary Policy in a New Era. Prepared for conference on Rethinking Macroeconomic Policy, Peterson Institute, October

[16] E.g. Sharpe, S.A. and Suarez, G.A. (2014). Why isn't Investment More Sensitive to Interest Rates: Evidence from Surveys. 002, Finance and Economics Discussion Series, Federal Reserve; Lane, K. and Rosewall, T. (2015). Firms' Investment Decisions and Interest Rates. *Bulletin*, Reserve Bank of Australia, June, pp. 1-7

Since the crisis, the Bank of England's main policy interest rate (known as the 'Bank rate') has been trapped near the zero-lower bound (at 0.5 per cent from March 2009, 0.25 per cent from August 2016 to November 2017, and at 0.75 per cent since August 2018).[17] As the business cycle matures and rates remain below one per cent, policymakers are running out of options for the response to another crisis should one materialise. The Bank's Deputy Governor for monetary policy, Ben Broadbent, has suggested that further asset purchases might be required.[18] However, the effects of QE are also uncertain – it isn't clear what volume of purchases is required for a specific effect on output and inflation, nor how long the effect lasts.[19] Moreover, a greater reliance on quantitative easing (QE) simply worsens a separate problem, concerning the distributional effects of monetary policy.

Distributional effects can't be ignored

Interest rate changes have long favoured certain groups in society (the primary divide being between creditors and debtors), but the central banks' expansive new policy toolkit has stoked further controversy. The argument for independence assumes that decisions made by unelected officials have no such politically sensitive effects. Box 1 discusses evidence of *distributional* effects with respect to wealth and income which contradict this assumption.

However, this is not the only concern. Goodhart and Lastra refer also to the ways central bank policy results in (implicitly) preferential treatment for some economic sectors, which they term *'directional'* effects. Examples include the design of eligibility criteria for corporate bond purchases (such as those operated by the Bank of England and the European Central Bank); and risk-weights, attached to particular asset classes, governing the total amount of capital banks are required to hold against loans. The same authors also refer to effects on the *duration* of government debt that result from central bank interventions, noting that QE will lead to an increasing cash-flow to banks, once interest rates rise, due to a massive expansion of reserves they hold at the central bank.[20]

[17] Bank of England (2019). Official Bank Rate history. Accessed on 03/04/2019, available at: https://www.bankofengland.co.uk/boeapps/database/Bank-Rate.asp

[18] Wallace, T. (2018). 'Bank of England has "plenty of firepower" left to ramp up QE, says Deputy Governor'. *The Telegraph*, 6 December. Accessed on 01/04/2019, available at: https://www.telegraph.co.uk/business/2018/12/06/bank-england-has-plenty-firepower-left-ramp-qe-says-deputy-governor/

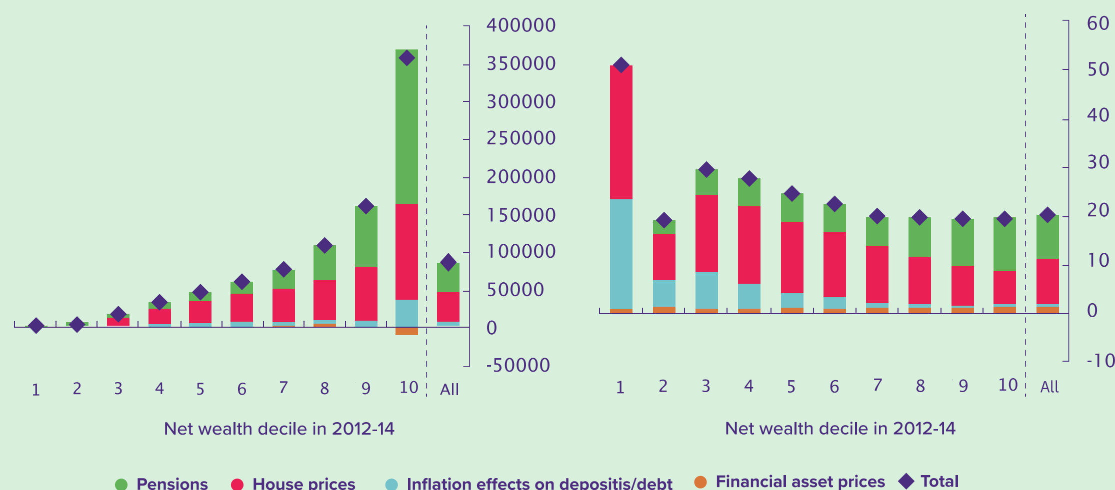
[19] Joyce M., Miles D., Scott A. and Vayanos D. (2012). 'Quantitative easing and unconventional monetary policy – an introduction'. *The Economic Journal*

[20] Goodhart, C. and Lastra, R. (2018). 'Potential threats to central bank independence'. VoxEU, March. Accessed on 20/09/2019, available at: https://voxeu.org/article/potential-threats-central-bank-independence

Box 1: Inequality and monetary policy since the financial crisis

A flashpoint for the legitimacy crisis faced by central banks since 2008 has been inequality and the impact of policy decisions on the distribution of wealth and income.[21] In their critique of the framework of independence for the Federal Reserve, Jacobs and King call the American central bank an 'inequality generator'.[22] A variety of studies suggest central bank policy can have a significant effect on inequality. In particular, quantitative easing has been shown to increase inequality in the UK,[23] United States[24] , and Japan[25]. In addition, bank bailout policies are also likely to benefit high-wealth households more than others.[26]

In response to critics of post-crisis monetary policy, Bank of England staff published their own research on the link between the Bank's policies and the distribution of income and wealth in the UK.[27] The results were mixed. The effect on the wealth of households was deeply unequal in *cash* terms: on average, households in the poorest decile of the wealth distribution gained approximately £3000, while those in the richest gained £350,000. However, the Bank argued that the gains should be expressed in percentage terms (i.e. as a proportion of the household's pre-existing wealth). Figure 2 shows how expressing the wealth changes in *proportional* terms makes the distributional effect seem much more even.



Effects of monetary policy changes since 2007 on net wealth by wealth decile in cash terms

Effects of monetary policy changes since 2007 on net wealth by wealth decile in percentage terms

Figure 2: Estimates of the effects of Bank of England monetary policy on the distribution of wealth in the UK
Source: Bunn et al. (2018) [28]

[21] See e.g. Inman, P. and Osborne, H. (2016). 'Bank of England's recovery policies have increased inequality, finds S&P'. *The Guardian*, February 10. Accessed on 05/04/2019, available at: https://www.theguardian.com/business/2016/feb/10/bank-of-englands-recovery-policies-inequality-standard-and-poors

[22] Jacobs, L.R. and King, D. (2016). *Fed Power: How Finance Wins.* Oxford University Press. p. 3

[23] Mumtaz, H. and Theophilopoulou, A. (2016). The Impact of Monetary Policy on Inequality in the UK. An Empirical Analysis. Working Paper No. 783, Queen Mary University of London School of Economics and Finance, February

[24] Montecino, J.A. and Epstein, G. (2015). Did Quantitative Easing Increase Income Inequality? Working Paper No. 28, Institute for New Economic Thinking, October

[25] Saiki, A. and Frost, J. (2014). 'Does unconventional monetary policy affect inequality? Evidence from Japan'. *Applied Economics*, Vol. 46, No. 36, pp. 4445-4454

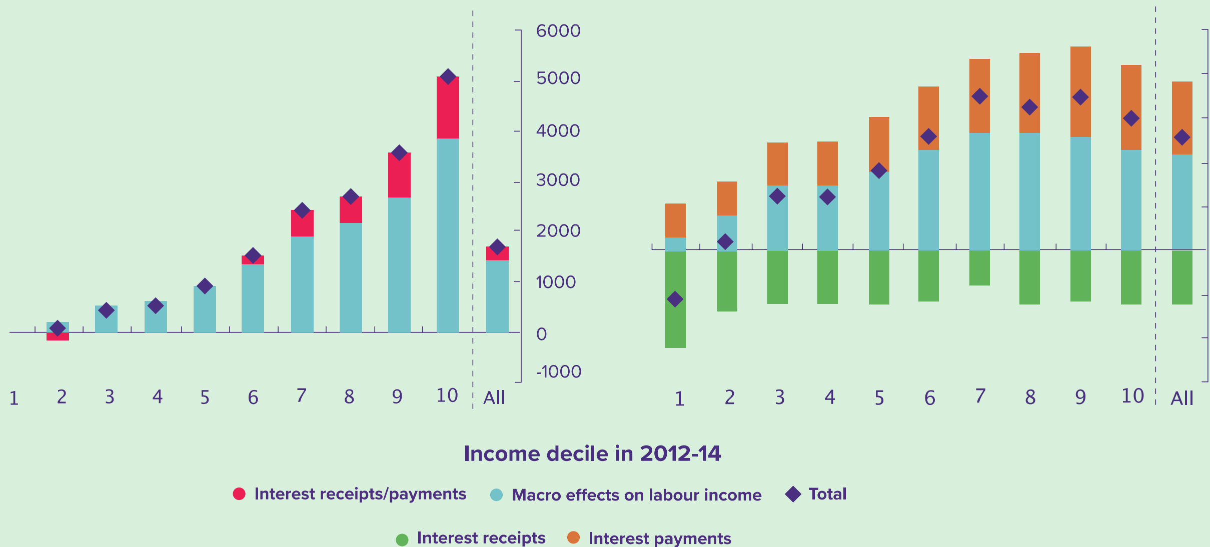
[26] Mitkov, Y. (2016). Inequality and Financial Fragility. Department of Economics, Rutgers University, October

[27] Bunn, P., Pugh, A. and Yeates, C. (2018). The distributional impact of monetary policy easing in the UK between 2008 and 2014. Bank of England Staff Working Paper No. 720, March

[28] Ibid., p. 26

However, some problems remain. The first is that the effect operates on different forms of wealth across the distribution of households. For instance, households at the top are far richer in financial assets (the Gini coefficient on financial wealth increased by around 10 percentage points over the post-crisis decade [29]). It is unclear whether both types of wealth are equally pertinent to living standards. Secondly, comparable results for the effects on the income distribution were less favourable. As Figure 3 shows, the estimated impact on a household's income, expressed by decile in proportional terms, mainly increased up the distribution. Households in the bottom decile experienced a negative income effect.

Finally, the research only considered the effect of Bank policy vis-à-vis a counterfactual where it took no action, skewing the results (since allowing the recession to run its course would have had extremely damaging effects). It did not examine the likely difference between the Bank's course of action and other potential methods of stimulating the economy, such as alternative forms of public money creation.



Effects of monetary policy changes since 2007 on income by incomce decline in cash terms

Effects of monetary policy changes since 2007 on income by incomce decline in percentage terms

Figure 3: Estimates of the effects of Bank of England monetary policy on the distribution of income in the UK
Source: Bunn et al. (2018) [30]

However, in accountability terms, the debate showed a promising way forward. In a speech delivered to publicise the research conducted at the Bank, Chief Economist Andy Haldane examined the possibility of displaying a 'monetary policy scorecard'.[31] This would let observers and citizens compare a range of demographic profiles and the Bank's estimates for how monetary policy decisions would affect their income and wealth. This could be one ingredient in a range of measures to improve central bank communication, discussed in Chapter 3.

[29] Office for National Statistics (2018). Wealth and Assets Survey Wave 5

[30] The distributional impact of monetary policy easing, p. 24

[31] Haldane, A. (2018). How Monetary Policy Affects Your GDP. Speech given at the Finch Lecture, University of Melbourne, April 10. Accessed on 20/09/2019, available at: https://www.bankofengland.co.uk/speech/2018/andy-haldane-david-finch-public-lecture-melbourne

The financial stability remit is not a clear goal

While inflation and output are (to an extent) quantifiable and amenable to established targets for an independent agency to pursue, the same cannot be said of financial stability. Under the Financial Services Act 2012, the Bank of England received a mandate to 'protect and enhance the stability of the financial system of the United Kingdom.'[32] This was a response to the failings of the 'tripartite' arrangement in place before the financial crisis, where the Bank ceded responsibility for financial stability to the Financial Services Authority.

However, the new arrangement is not readily compatible with *democratic* legitimacy. This is because no clear metric exists for measuring the presence or absence of financial stability. Moreover, the regulatory and supervisory tools the Bank uses to control the banking system are arcane, and transparency is lacking. These issues mean that elected representatives in government or Parliament are unable to properly scrutinise the Bank's financial stability work and hold its officials to account.

The Bank of England's mandate is fundamentally contested

Speaking to its most fundamental assumption – that society's preferences are known and stable when it comes to the inflation-unemployment trade-off – in 1997, Joseph Stiglitz, then Chief Economist of the World Bank, challenged the prevailing view of central bank independence. He indicated some crucial doubts which, though ignored by most of the policy establishment, remained unanswered:

1. Is this degree of removal from public accountability necessary for achieving the degree of independence that would be warranted by improved economic performance?
2. Have we marshalled the quality of expertise that the country could, and should, obtain?
3. Have we achieved the best balance between stabilization and fighting inflation?[33]

These remain open questions today. Indeed, Stiglitz's questions characterise some of the main threads in the struggle to address central bank legitimacy, including transparency, scrutiny and dialogue, and the backgrounds and biases of policymakers. But the entire framework ultimately turns on the third and final question. Legitimacy rests on the existence of a social consensus over how the central bank ought to weigh various possible objectives, including inflation and unemployment, but also financial stability and growth. Evidence suggests society's preferences do not necessarily match up to the strong emphasis on price stability engrained in the Bank of England's mandate.[34]

[32] Bank of England Act 1998. Section 2A.

[33] Stiglitz, J. (1997) 'Central Banking in a Democratic Society'. *De Economist* 146:2, pp. 223-224. For a similar, if more trenchant critique, see McNamara, K. (2002) 'Rational Fictions: Central Bank Independence and the Social Logic of Delegation'. *West European Politics*, 25:1, 47-76

[34] Di Tella, R., MacCulloch, R.J. and Oswald, A.J. (2001). 'Preferences over Inflation and Unemployment: Evidence from Surveys of Happiness'. *The American Economic Review*, Vol. 91, No. 1 (Mar., 2001), pp. 335-341

Legislation that provides the basis for independence must make provisions for ensuring that consensus is durable and amending the central bank's goals if not. In fact, several proposals have been made for a new mandate for the Bank of England. Suggestions have included adding a growth target,[35] a target for house price inflation,[36] a target for productivity growth,[37] and clauses to highlight the environmental impact of Bank policy.[38] Each of these proposals has its relative economic advantages. The important common point is that new mandates must consider the tools the central bank possesses to pursue any new objectives, that those objectives can be clearly stated and measured as a policy goal, and that the objectives are consistent with the general principles that secure democratic legitimacy.

In other words, if the Bank is handed a transformed set of responsibilities, a new accountability architecture will also be necessary. However, whatever the set of responsibilities, the question of how the Bank is accountable to an elected Parliament is crucial. This paper will not propose any particular reform of the mandate. Instead, Chapter 5 will consider one area that we believe is crucial to promoting stable and effective economic policy - credit policy - which is currently overlooked, to the detriment of legitimacy.

[35] Yueh, L. (2018). 'Why the Bank of England Should Target Growth'. *Project Syndicate*, August 10. Accessed on 09/04/2019, available at: https://www.project-syndicate.org/commentary/bank-of-england-should-target-growth-by-linda-yueh-2018-08

[36] Blakeley, G. (2018). On Borrowed Time: Finance and the UK's current account deficit. Institute for Public Policy Research, June

[37] GFC Economics and Clearpoint (2018). Financing Investment:

[38] Macquarie, R. (2018) A Green Bank of England. Positive Money, May

1.2 Transparency matters

One important property of an accountable regime is that it is transparent. Releasing information to the public domain is necessary for society to be able to hold decision-makers accountable. However, legitimacy cannot be reduced to transparency. For a start, reciprocal channels of dialogue are also required for effective accountability, as a forum for the information disclosed by the central bank to be scrutinised by civil and political actors. Releasing information alone is not enough; only through listening to others can central banks have confidence they maintain the public's trust.

Many initiatives to improve transparency take the traditional model of an independent central bank – with quite specific goals and instruments – for granted. Moreover, Riles notes that central bank staff work and operate in a particular cultural setting, one dominated by experts but essentially alien to the regular experience most people have of the economy.[39] This cultural clash can undermine efforts to be transparent, as information central banks consider important to release might not correspond to what the public expects from them. Finally, relying on transparency assumes a stable degree of respect and deference to expertise among the public. This, as Riles explains, is a weak strategy for legitimacy:

> **"...delegated authority is also an incomplete foundation for public trust —because the public holds its elected officials in as much disregard as the experts, because that authority can always be revoked, and because delegation of authority does not resolve questions in the public mind about the motivations and social networks of the experts."** [40]

In other words, fixed structures of delegation to experts can become brittle over time, as the post-crisis period shows. A much more robust form of legitimacy would allow mechanisms for society to have a say on whether the institutional model they have is appropriate, which values it should be promoting, and whether it strikes the right balance on unavoidable trade-offs.

1.3 Towards a new settlement

Given all the reasons listed above, it should not be surprising that central banking appears to be in flux, and that the Bank of England frequently occupies the political spotlight. There has been a return to the question Hartwell expresses as the 'normative reason for a central bank's existence' – 'why it should exist'.[41] That ought to be stabilising the economy and making sure the banking system is fit for purpose. Indeed, one symptom of the breakdown in the conventional model for managing the financial system is growing interest in the idea of the 'purpose' of the financial system.[42]

There are certain design features to which any independent central bank must have its own answer. Three that occur repeatedly within the literature on independence[43] are appointments (i.e. how central bankers themselves are chosen), communication with the public and their representatives, and coordination with the fiscal authority during economic downturns.

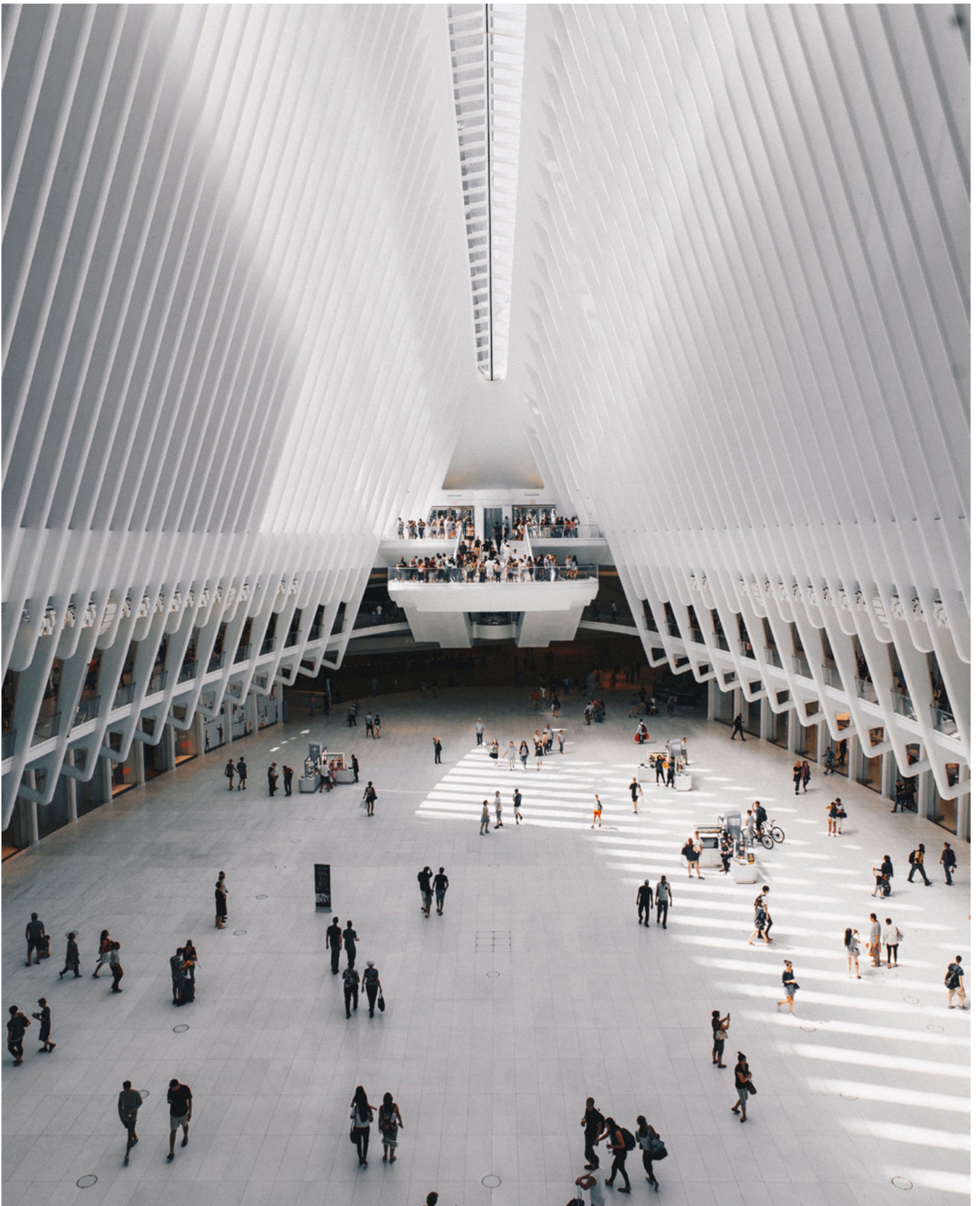
[39] *Financial Citizenship*, pp. 26-27

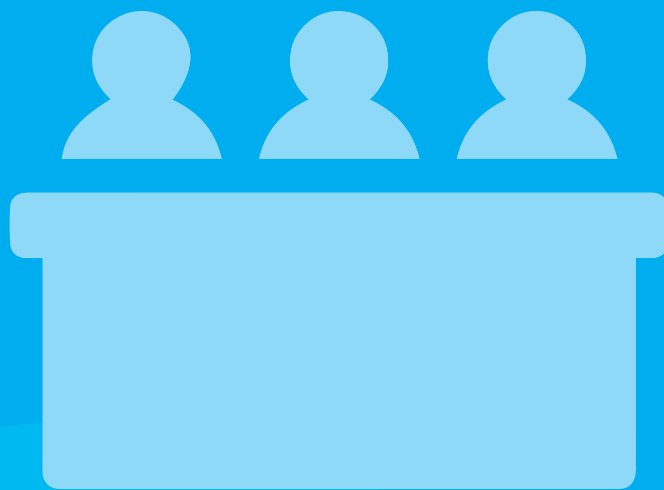
[40] Ibid., p. 53

[41] Hartwell, C.A. (2019). On the impossibility of central bank independence: four decades of time- (and intellectual) inconsistency. *Cambridge Journal of Economics*, Volume 43, No. 1. p. 63

[42] Pitt-Watson, D. and Mann, H. (2017). The Purpose of Finance: Why Finance Matters: Building an industry that serves its customers and society. Pension Insurance Corporation; Financial Innovation Lab (2018). The Regulatory Compass. July

[43] See e.g. Mayes, D.G., Siklos, P.L. and Sturm, J.-E.(2019). *The Oxford Handbook of the Economics of Central Banking.* Oxford University Press





Chapter 2:

COMMITTEES AND APPOINTMENTS

An assumption of the orthodox economic literature is that decision-makers in central banks have the 'right' set of preferences. To receive the benefits of sound economic management, monetary policymakers must weigh the trade-off between inflation and output to maximise social welfare. This process is conducted by committee – at the Bank of England, by the aptly named Monetary Policy Committee (MPC).

Contemporary critics claim that policymakers are overly averse to inflation and are more willing to pay the cost of controlling it, in terms of higher unemployment and the impact of higher interest rates, than really necessary to maximise public welfare.[44] In other words, the preferences of the experts and the best interests of society no longer align.

However, many modern central banks do not only conduct monetary policy. The Bank of England also engages in extensive regulation of the financial sector (including prudential supervision, stress testing, and macroprudential measures), with significant consequences for the structure of society and collective prosperity. In that case, the trade-off might be thought of as between stability and credit. However, the financial stability objective is problematic, because it does not translate into a clear goal and regulation is inherently opaque. This makes accountability of independent decision-makers more important for legitimacy, not less.

Several hazards lurk in the decision-making process. The models used to implement a particular function might also be wrong, or perhaps the public simply hasn't been able to inform decision-makers of its updated preferences (see chapter 3). The most basic factor is the identity of decision-makers themselves. For independent central banks, the composition of decision-making committees depends on how their members are appointed. This chapter examines the case for diversity on committees and examines how the appointment process could help improve this at the Bank of England.

[44] For example, see Fed Up: http://whatrecovery.org/

2.1 How committee membership affects policy

Several empirical studies have shown that monetary policymakers' backgrounds influence their policy choices. Gohlmann and Vaubel analyse the euro area and eleven countries since 1973, finding that former members of the central bank staff prefer significantly lower inflation rates than former politicians do.[45] For major OECD countries in the 1999 to 2010 period, Farvaque *et al*. study the influence of a policymakers' background. Committee members from academia, the central bank itself, and the financial sector all contribute to lower output and inflation volatility, although financial sector employees lose their effectiveness bonus during crises.[46] And Neuenkirch & Neumeier investigate OECD countries, finding that affiliation to a political party has the strongest influence on a central banker's monetary policy stance. [47]

Studies extend to specific central banks. A link has been shown between reform proposals advanced by members of the European Central Bank's Governing Council and those members' educational and occupational backgrounds.[48] In the case of the United States' Federal Reserve, while education and age don't appear to have such a strong influence on FOMC member voting patterns, time spent within the Federal Reserve system leads decision-makers to favour higher policy interest rates and lower levels of inflation than their peers.[49]

In the case of the Bank of England, some research suggests that the occupational background of MPC members has only a small impact on their likelihood of 'dissenting' (voting against the majority).[50] However, such studies are limited by the range of experience actually found among historic members - there has rarely been anyone from civil society on the MPC. Moreover, as discussed below, interactions between committee members that *shift the median vote* and help the Bank to pay attention to a wider variety of factors - rather than increasing dissent *per se* - are possibly the most significant impact of including diverse voices on committees.

Decision-maker identity also affects financial regulation. Noting a broad swing towards a closer relationship between central banks and the financial sector - the proportion of governors that had past experience in finance increases from 10 percent in 1980 to 30 percent in 2010 - Mishra & Reshef find important evidence of a connection between governor experience and policy outcomes. **A central bank governor with financial sector experience deregulates three times more than a governor without financial sector experience.** [51]

[45] Gohlmann, S. and Vaubel, R. (2007). 'The educational and occupational background of central bankers and its effect on inflation: An empirical analysis'. *European Economic Review*. Vol. 51, pp. 925-941

[46] Farvaque, E., Stanek, P. and Vigeant, S. (2014). 'On the Performance of Monetary Policy Committees'. *KYKLOS*, Vol. 67, No. 2, pp. 177-203

[47] Neuenkrich, M. and Neumeier, F. (2013). Party affiliation rather than former occupation: The background of central bank governors and its effect on monetary policy. Joint Discussion Paper Series in Economics, No. 36-2013

[48] Bennani, H. (2017). 'Dissecting the brains of central bankers: The case of the ECB's Governing Council members on reforms'. *International Economics*, Vol. 141, pp. 97-114

[49] Smales, L.A. and Apergis, N. (2016). 'The influence of FOMC member characteristics on the monetary policy decision-making process'. *Journal of Banking & Finance*, Vol. 64, pp. 216-231

[50] Harris, M.N., Levine, P. & Spencer, C. (2011). A decade of dissent: explaining the dissent voting behavior of Bank of England MPC members. *Public Choice,* Vol. 146, No. 3-4, pp. 413-442

[51] Mishra, P. and Reshef, A. (2018). 'How Do Central Bank Governors Matter? Regulation and the Financial Sector'. J*ournal of Money, Credit and Banking*, Vol. 51, No. 2-3

Since not all decision-makers are alike, whoever makes the appointments has some, albeit very indirect, control over policy outcomes. In other words, 'independent agencies' like central banks are less independent than it first seems. Ainsley adjusts conventional models to account for 'monetary uncertainty' – a recognition that 'the central bank cannot perfectly determine inflation with its policy choices'. The government then alters its appointment strategy to promote more inflation-tolerant central bankers, a theoretical adjustment supported by evidence from the Bank of England and Hungary's central bank. [52]

Hix *et al*. also show how politics affects policy outcomes, through a 'spatial analysis' of voting in the Bank of England's MPC. They construct new measures of the preferences of MPC members concerning output and inflation and use these to show that 'the British Government has been able to move the position of the median voter on the MPC through its appointments to the Committee.' In short, **the ability of the appointment process to make a substantive change to the outcomes of policy makes it a crux for central bank legitimacy.**

[52] Ainsley, C. (2017). 'The Politics of Central Bank Appointments'. *The Journal of Politics*, Vol. 79, No. 4, pp. 1205-1219

The benefits of diversity

An inquiry by the House of Commons' Treasury Select Committee (TSC) in 2007, to mark 10 years of the Bank of England's independence, revealed a clear consensus among experts that diversity of experience is a highly valuable feature of committees. Several experts, including Dr Andrew Sentance and Dr David Potter indicated the benefit of a balance on the MPC between professional bankers, other expert economists, and individuals with a business background. [53]

As central banks have struggled with their legitimacy crisis, calls for diversity have sharpened. Senior figures have admitted a problem exists – that the culture of central banking remains relatively homogenous – and have developed strategies to tackle it. The goal is to avoid 'groupthink', which threatens to replace critical, independent thinking in groups with a cohesive, amiable membership (such as policymaking committees).[54] Mark Carney, Governor of the Bank of England, noted in a speech that 'we need a richness of ideas and perspectives that are exchanged in the pursuit of clear goals under an overarching mission.'[55]

Shifting the focus to 'cognitive diversity' might be logically correct, but it is evasive. The important question is how best to encourage diversity of thought through design of the recruitment process. In fact, what Carney labels 'identity factors' are key drivers of an individual's mode of thinking. There is a wealth of evidence to demonstrate that gender, ethnicity, age, sexual orientation, disability, socioeconomic background, and career experience are some of the factors that influence individuals' life prospects, lived experience, and therefore their cognitive biases.[56] Box 2 examines the influence of one such factor, gender, which has received the most attention in public debate. **Yet to ensure the best chance of beating groupthink, central banks should promote diversity across all these factors.**

[53] House of Commons Treasury Select Committee (2007). The MPC of the BoE Ten Years On pp. 28-29

[54] Janis, I. (1982) *Groupthink*. Boston: Houghton Mifflin, p. 8

[55] Carney (2017) 'Reflecting Diversity, Choosing Inclusion'. See also Mohan (2013) 'Need for Thought Diversity to Combat Group-Think in Central Banking'

[56] Greenwaldt, A. G., Krieger, L. H. (2006). Implicit Bias: Scientific Foundations. California Law Review. Vol. 94, July 2006, No. 4. Accessed on 20/09/2019, available at: https://scholarship.law.berkeley.edu/cgi/viewcontent.cgi?article=1250&context=californialawreview

Box 2: Inclusion of women on senior boards

Recent debates have levelled renewed scrutiny at the stark gender inequality that characterises the upper echelons of economics and finance. Janet Yellen's tenure as Chair of the Federal Reserve Board of Governors from 2014 to 2018 heightened the visibility of the gender question. In October 2017, Nicky Morgan, the chair of the UK's Treasury Select Committee, wrote to Chancellor Philip Hammond about the Committee's concern 'about [gender and ethnic] diversity at the most senior levels in the Bank of England.'[57]

Central bank troubles are one manifestation of gender imbalance in the financial services sector more broadly. The TSC published the results of its 'Women in Finance' inquiry in 2018, which reviewed the value to financial firms of having a superior gender balance. It featured research conducted in 2015, covering 200 financial services firms, which found the overall average was 23 per cent female representation on boards, and 14 per cent on executive committees.

Evidence suggests that female participation on decision-making boards has a dramatic positive impact on organisational performance. For instance, according to Credit Suisse, "companies with at least one female director had generated… excess return per annum of 3.3 per cent for investors over the previous decade… [and] companies where women made up at least 15 per cent of senior managers had more than 50 per cent higher profitability than those where female representation was less than 10 per cent." [58] Other studies corroborate this striking finding.[59] While these relationships are correlational and not strictly causal, diversity and good decisions go hand in hand.

In the context of central banking, the relationship is not with profits but with effective and efficient policymaking. There is not much certainty over the difference between male and female policymakers in terms of voting records. Data from the US Federal Reserve reveal that women tend to be more tolerant of inflation. Wider data from a range of OECD countries implies the opposite.[60] However, the most important effects of greater gender balance are not captured by voting records alone. It is the interaction between committee members with a less homogeneous range of perspectives that may improve policy. As the authors of an OMFIF report write, '[by] including women in the process, gender-influenced biases and risk approaches can be mitigated.' [61]

[58] Credit Suisse (2016). *The CS Gender 3000: The Reward for Change.* September

[59] For the UK, see: Agyemang-Mintah, P. & Schadewitz, H. (2018). 'Gender diversity and firm value: evidence from UK financial institutions', *International Journal of Accounting & Information Management*, Vol. 26, No. 3; for Spain. Accessed on 20/09/2019, available at: https://www.napier.ac.uk/research-and-innovation/research-search/outputs/gender-diversity-and-firm-value-evidence-from-uk-financial-institutions

For Spain, see: Reguera-Alvarado, N., de Fuentes, P. & Laffarga, J. J Bus Ethics (2017) 141: 337. https://doi.org/10.1007/s10551-015-2735-9

[60] Masciandaro, D., Profeta, P. and Romelli, D. (2016). Gender and Monetary Policymaking: Trends, Drivers and Effects, Baffi Carefin Centre, Bocconi University, Working Paper Series, 15.

[61] Kyriakopoulou, D. and Usita, K. (2019). 'Why Diversity Matters'. In *Banking on Balance: Gender Balance Index 2019*. Official Monetary and Financial Institutions Forum, March. p. 4

Diversity and monetary policy

There is a growing consensus that more diverse committees should make for better monetary policy. Macroeconomic stabilisation requires understanding all the dimensions of the economy: not only how money and banking functions, but also the implications for real (not just 'representative') households and businesses. These are complex processes, open to multiple interpretations.

The call for more diverse experience is linked to a wider initiative to increase 'pluralism' in economics.[62] The dominance of neoclassical economics in academic teaching of the subject has resulted in several problems outlined by Thornton: 'an overreliance on highly unrealistic theoretical assumptions, an over-use of mathematical modelling, the exclusion of many important variables and relationships, and the failure adequately to incorporate crucial insights from other academic disciplines such as politics, philosophy, psychology, history and sociology'; and that "particular theories are persisted with long after empirical evidence has suggested that they be abandoned or significantly altered."

All of these shortcomings could cripple monetary policy's effectiveness. However, one thing is clear: for an independent central bank to be at all legitimate, we must at least agree on *some* model or tool for understanding the economy and making monetary policy decisions. If pluralism means that no such model really exists, or that we cannot discern which is best, then the crucial assumptions for legitimacy in Chapter 1 are not satisfied. Therefore, since there is only so far the model can bend, there is an even greater reason to increase pluralism via the range of perspectives policymakers bring to the process. As Carruthers and Kim claim in a sociological study of finance,

> **"We should not simply ask if the model was accurate or not. Rather, we should study how the model was enacted, applied, or performed so that it could become more or less true."** [63]

Diversity and financial regulation

By contrast with monetary policy, designing financial regulation does not draw on such a wide range of economic factors, and the resultant policies target specific firms rather than the economy as a whole. The arguments for diversity are therefore different.

Financial policy committees are therefore more vulnerable to the charge of capture by private interests. Measures to protect financial stability can be burdensome for firms, creating incentives for policymakers with factional interests to water down regulation. Discussing a bill introduced to the United States Congress in January 2016, presidential candidate Senator Bernie Sanders pointed to what he saw as "clear conflicts of interest, the kind that would not be allowed at other agencies… We should not allow big bank executives to serve on the boards of the

[62] Thornton, T.B. (2016). *From Economics to Political Economy: The problems, promises and solutions of pluralist economics.* London, Routledge. See also http://www.rethinkeconomics.org/

[61] Kyriakopoulou, D. and Usita, K. (2019). 'Why Diversity Matters'. In Banking on Balance: Gender Balance Index 2019. Official Monetary and Financial Institutions Forum, March. p. 4

[63] Carruthers, B.G. and Jeong-Chul Kim, J-C. (2001). The Sociology of Finance. *Annual Review of Sociology*, Vol. 37, No. 1, p. 251

main agency in charge of regulating financial institutions."[64] Former employees of the financial sector may well display biases in knowledge and judgment that result in a less critical view of the industry, with the potential to skew policy in favour of financial institutions.

At the same time, understanding and deciding over financial regulation arguably requires a much greater familiarity with how financial institutions work. That makes former financial sector employees a natural choice for policymakers in terms of skills and knowledge. This bias towards financial sector employees is problematic since they tend towards deregulation of the finance sector, as noted in section 2.1. There is less scope for a pluralist approach to regulation, since the instruments and issues involved are themselves extremely specialised. While some identity factors such as gender could still be prioritised for appointment to the PRC and FPC, there is less room for adjustment to the appointment process to promote a diversity of experience and backgrounds.

[64] Sanders, B. (2015). 'To Rein In Wall Street, Fix the Fed.' The New York Times. Accessed on 20/09/2019, available at: https://www.nytimes.com/2015/12/23/opinion/bernie-sanders-to-rein-in-wall-street-fix-the-fed.html; see also Summers, 'Here's what Bernie Sanders Gets Wrong - and Right - about the Fed'

2.2 Diversity at the Bank of England

Bank of England policy is made by three crucial decision-making committees. The MPC is a nine-person committee that sets and announces policy eight times a year. Five of the members are 'internal', in that they are senior and permanent members of the Bank staff (including the Governor and three Deputy Governors). The other four are 'external' members, without any permanent ties to the Bank. It holds several meetings to prepare for these decisions.

Two other committees exist alongside the MPC following reform to the Bank after the financial crisis of 2007-08. The Financial Policy Committee (FPC) is responsible for 'macroprudential' regulation – monitoring systemic risks to the financial system and deploying regulatory instruments to mitigate them. The Prudential Regulation Committee (PRC) also handles financial regulation, but at a more granular level ('microprudential'). The PRC is in charge of the Prudential Regulation Authority, the entity within the Bank's structure responsible for regulating particular firms. The FPC normally consists of 13 members; the PRC counts 12.

Following a common pattern across central banks, women are conspicuously underrepresented on all three of the Bank's policymaking committees. The Bank's 120 governors have all been men. Out of 43 members of the MPC since the Bank gained its independence, 8 have been women. **Male members of the committee have voted to raise the policy interest rate just over twice as often as female members.**[65]

The Bank's strategy to improve diversity addresses the main body of its staff rather than the committees per se, reflecting a problem with homogeneity in the institution more widely. Figure 4 reveals that, in comparative terms, the Bank is worse at promoting women in its staff to managerial positions than, say, the Fed. While the Bank has moved closer to its 2020 target for women to fill 35 percent of such roles, progress has stalled. The proportion stood at 29 per cent in 2018, up from 22 per cent in 2014.[66] While improvement is promising, there is no reason for the target adopted to remain lower than the equivalent ratio in the wider civil service – estimated at 40.1 per cent in March 2016.[67] Moreover, in the same timeframe, the proportion of female representation below senior management has crept up to 45 per cent from 44 per cent, implying the Bank's hiring practices are struggling to address the imbalance.

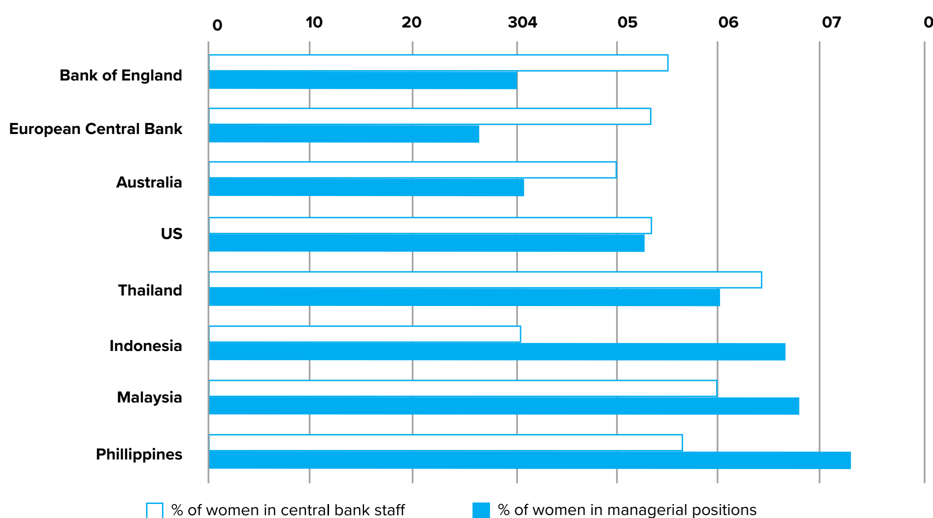


Figure 4: Female representation at the Bank of England is mediocre by international standards
Source: Bloomberg [68], Bank of England [69] ; 2017 figures

[65] Bank of England (2018). Monetary Policy Committee voting history. Accessed on 11/10/2018, available from: https://www.bankofengland.co.uk/about/people/monetary-policy-committee

[66] Bank of England (2019). Annual Report 2018. p. 39

[67] National Audit Office (2016). Progress Towards Delivering the OneBank Strategy. p. 32

Among senior staff positions, the proportion of BAME people fell to 5 per cent in 2018. This is below the civil service average,[70] and is significantly below the population as a whole.[71] BAME representation below senior management has moved up from 16 per cent in 2015 to 18 per cent in 2018.[72]

The Bank of England also performs poorly in terms of the number of board members with backgrounds in business (other than the financial sector) and civil society. The current PRC is almost entirely composed of individuals with a background in either a public economic institution or the financial sector. However, as discussed above, this is partly a consequence of the committee's duties. Yet the concentration, and by extension the homogeneity of perspectives, is striking.

In the case of the MPC, as Figure 5 shows, one quarter of the MPC's historic members formed the bulk of their experience in private finance. The amount of career experience in the financial sector among serving MPC members has risen over time. [73]

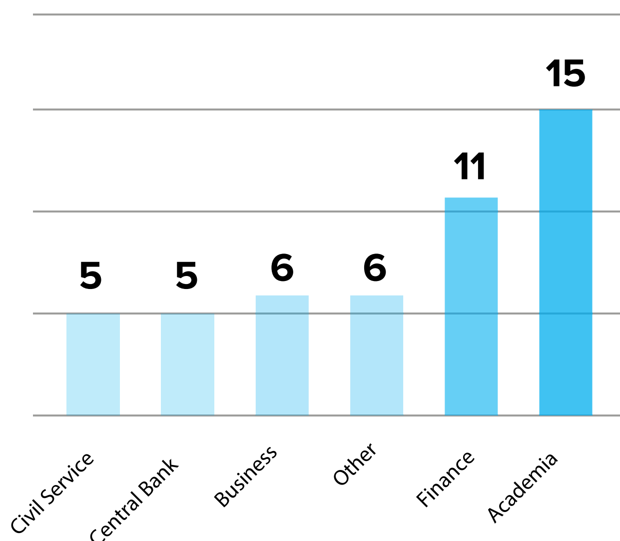


Figure 5: Members appointed to the MPC from 1997 to 2018 were drawn largely from the financial sector, the central bank itself, or elsewhere in the civil service.
Source: House of Commons records, affiliated institutions and firms

Given progress improving diversity among Bank staff is incremental at best, there is an argument for direct interventions at the appointment stage to rapidly improve diversity on its committees.

[68] Bloomberg (2017). Women in Finance: Where in the World is Gender Equality Gaining Ground? March

[69] Annual Report 2018

[70] Ibid.

[71] Office for National Statistics (2012). Ethnicity and National Identity in England and Wales: 2011. December

[72] Bank of England (2019). Annual Report 2018. p. 39

[73] Harris *et al*. (2011). 'A decade of dissent', p. 427

2.3 The appointment process

Importantly, almost all the political appointees to the MPC are made by the executive branch of the UK government. The Chancellor of the Exchequer appoints the external members directly, while the Governor and some Deputy Governors are Crown appointments (meaning the Prime Minister advises the Queen to make the appointment).

The 2007 inquiry by the TSC tackled the question of appointments to the Bank's MPC head-on. At the time, the process was opaque and secretive. Professor Charles Goodhart argued that "there is no information or attempt to give any specification about what is wanted. How the Chancellor and Treasury go about obtaining names and what the role of the Governor of the Bank is in this is simply unknown".[74]

At that time, the Governor had significant leeway in providing the Treasury with a list of potential candidates, and the Treasury was able to filter candidates on a seemingly ad hoc basis. For instance, in its report on the appointment of Richard Lambert to the MPC in June 2003, the Committee noted that "Mr Lambert was recruited on the basis of telephone conversations with Treasury officials"; the report suggested "that it might be more appropriate to have a more formal system for appointments in future." [75] The inquiry also identified the potential for *too much* political influence, in that there is a wide scope for the Chancellor of the Exchequer to influence or alter the process.

In 2014, the Warsh Review addressed the question of transparency on the MPC, and whether sufficient measures were in place to "help the MPC achieve its objectives". The Review was conducted at the request of Governor Mark Carney. However, it omitted to mention the process by which appointments are made, focusing instead on the case for immediately publishing the rationale behind the policy decision, the merits of publishing meeting transcripts and minutes, and the number of meetings held each year.[76]

The TSC reviewed its own scrutiny of appointments in 2016. It was noted that the pre-commencement hearings it holds with appointees to the Bank's committees were established because the Bank of England Act 1998 did not contain provision for confirmation of nominees. These hearings have created a somewhat awkward role for the TSC. For instance, in the case of Charlotte Hogg's appointment to Deputy Governor, information uncovered during the TSC hearing resulted in her resignation. The TSC therefore appears to possess a de facto veto, in spite of the fact that its request for one has been repeatedly denied by government, including in 2016. [77]

The appointment process has also been at the centre of political controversy in light of the appointment of Jonathan Haskell, to replace Ian McCafferty, in May 2018. The choice of a man from a pool featuring more female than male candidates was seen in some corners as a failure of the appointment process. The Permanent Secretary to the Treasury, Sir Tom Scholar, noted that the 'Chief Economic Adviser to the Treasury, who chaired the interview panel, contacted 87 potential applicants to inform them of the vacancy, 44 of whom were women.' Four women and one man – Haskell – were interviewed.[78] This information was gradually released following pressure from the TSC.

[74] House of Commons Treasury Committee (2007). 'The Monetary Policy Committee of the Bank of England: ten years on'. July

[75] House of Commons Treasury Committee (2003). 'Appointment to the Monetary Policy Committee of the Bank of England of Mr Richard Lambert'. June

[76] Warsh, K. (2014). Transparency and the Bank of England's Monetary Policy Committee. December

[77] HM Treasury (2016). The Treasury Committee's scrutiny of appointments: government response. Cm 9305, July

[78] House of Commons (2018). 'Letter from Permanent Secretary, HM Treasury, regarding gender diversity on the MPC, 19 June 2018'. Accessed on 20/09/2019, available at: https://www.parliament.uk/documents/commons-committees/treasury/Correspondence/2017-19/ps-hmt-haskel-mpc-190618.pdf

As this debate indicates, the principal issue with the Bank of England appointment process is how opaque it is. Secrecy merely encourages greater public speculation and controversy. More importantly, the current process raises the threat of too much partisanship in the Chancellor's choice of candidates but allows little other democratic input (see Box 3). When the TSC takes a more assertive role, it results in controversy rather than calm deliberation.

To introduce more accountability and also stabilise the process, reforms should alter the balance of power and provide greater information to all participants, including civil society and the media. Greater public visibility of the decisions made throughout the process, and of the candidates under consideration, would prevent an erosion of trust in the Bank's important committees.

Box 3: Politically motivated appointments for Governor of the Bank of England

The political nature of the appointment process of the Governor of the Bank of England has come under scrutiny in recent years. In November 2012, special arrangements were made so that Mark Carney could apply for the job of Governor after the application process closed.[79] Additional adjustments permitted Carney to make a minimum commitment of a 5-year rather than 8-year term. He also received a London housing allowance of 250,000 pounds on top of his standard governor's salary, which took his total annual cash remuneration to 874,000 pounds - three times the previous Governor's salary.[80]

At the time of writing in August 2019 the newly appointed Chancellor, Sajid Javid, is overseeing the appointment of the Bank of England Governor. Whilst there is a good chance the current government appointing the Governor may not last more than a few months, they will be appointing a Governor for an eight year term. There are also rumours that the Governor may once again be appointed separately from the shortlist, as was the case with Mark Carney. This brings into question the whole appointment process and undermines basic HR practices carried out at the highest level of government.

The Chancellor should not be able to circumvent the process and appoint a Governor from outside the shortlist. If the initial shortlist is does not appear to have enough high calibre candidates the date of application should be extended rather than the process hi-jacked.

[79] House of Commons (2013). 'Appointment of Dr Mark Carney as Governor of the Bank Of England'. Eighth Report of Session 2012–13 Report. Accessed on 20/09/2019, available at: https://publications.parliament.uk/pa/cm201213/cmselect/cmtreasy/944/944.pdf

[80] Milliken, D. (2018) 'How does Britain choose a new Bank of England governor?' Reuters. Accessed on 20/09/2019, available at: https://uk.reuters.com/article/uk-britain-boe-appointment-factbox/factbox-how-does-britain-choose-a-new-bank-of-england-governor-idUKKCN1IM1F8

Box 4: Publication of Bank of England Governor shortlist

In September 2019, Positive Money coordinated a letter, signed by a cross party group of MPs, which called on the chancellor to publish the shortlist of candidates under consideration to replace Mark Carney as Bank of England Governor.

The letter argued that "it's crucial that the appointment of the next governor is made on merit, not narrow political expediency. For public trust in the central bank to be upheld, the process for choosing Mark Carney's successor must be fair, open and transparent. One simple way in which transparency can be increased is for the Treasury to publish a record of the candidates which have been shortlisted for the role." [81]

The letter notes that the International Monetary Fund has committed to publish the shortlist of candidates for its Managing Director position. It also makes the point that publishing the shortlist would allow Parliament to offer scrutiny during the appointment process, instead of the opportunity to do so being limited only to the Treasury Select Committee's pre-appointment hearing, which takes place after the decision has already been made.

The Treasury subsequently declined to reveal the shortlist. A spokesperson told City AM newspaper that 'it would not be appropriate to put personal information, including names from the shortlist, into the public domain.' [82]

[81] Letter to the Chancellor of the Exchequer calling for publication of the shortlist of candidates for Governor of the Bank of England. Co-ordinated by Positive Money. Accessed on 20/09/2019, available at: http://positivemoney.org/wp-content/uploads/2019/09/Letter-to-Chancellor-re-Governor-of-Bank-of-England-Sept-19.pdf

[82] Robertson, H. (2019). 'Treasury refuses MPs' demands to publish Bank of England governor shortlist'. City AM. Accessed on 20/09/2019, available at: https://www.cityam.com/treasury-refuses-demands-to-publish-bank-of-england-governor-shortlist/

Conclusion: committees, appointments and legitimacy

The UK could lead among central banks by constructing a genuinely pluralist central bank, justifying its wide-ranging responsibilities through broad-based membership of its committees. Two main areas invite reform.

First, **appointment processes should not be marked by secrecy, and must be as transparent as possible.** Greater scrutiny is needed over the 'diversity profile' of a central bank's committees. The Treasury (HMT) should make the process for seeking applicants far more transparent. That should include, at minimum, publishing a clear account of the details of how candidates are selected for the longlist. Once the longlist is decided, a 'blind' version should be published, showing the distribution of identity factors among the candidates. Effective scrutiny is the first step in making a credible commitment to diversity. High profile roles such as the head of the IMF or World Bank have a public shortlist. The shortlist of the Governor of the Bank of England should also be made public, a move supported by a cross-party group of MPs in 2019 (see Box 4).

Second, **committee and process design should actively promote new voices.** A wider range of backgrounds and profiles among MPC members would provide greater cognitive diversity. One step to achieve this would be to add an intermediate stage for the appointment process, where the Treasury presents a shortlist of candidates to the TSC, inviting a detailed response. The Bank and the Chancellor should also send a clear signal that a wider variety of applicants are welcome and encouraged, by making simple changes like alterations to the job description for committee membership. There can no longer be pushback from HMT when the TSC asks for further information.

Recommendations

- HMT should publish a clear explanation of how it gathers names to form a longlist of potential MPC appointments, and the steps it takes to reach applicants from a diverse range of gender, ethnic and occupational backgrounds. This should also describe the equivalent process for choosing a governor, and should occur before the next Governor of the Bank of England is appointed.

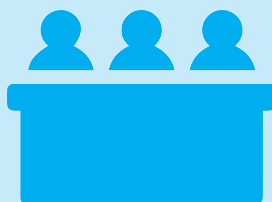
- HMT should publish a 'blind' longlist of candidates it settles on before choosing a shortlist to send to interview. This list should only feature certain important identity factors, while names should be hidden.

- HMT should alter the job descriptions in documentation advertising positions, so as to cast as wide a net as possible.[83] The Monetary Policy Committee (MPC) candidate profile – which presently reads, 'Candidates must demonstrate that they have used their economic expertise operating at a very senior level in business, financial markets, a policymaking environment or academia' – should include 'trade unions or other civil society organisations.' Another important addition should be a clause under 'Equality of Opportunity' welcoming applicants who are female or from an ethnic minority (to expand on the current provision that 'all disabled applicants will be guaranteed an interview by HM Treasury').

- The TSC must be privately presented with a shortlist of candidates before the decision is made. The TSC could then issue a formal response and recommend the Treasury and Chancellor prioritise certain factors.

- The shortlist for Governor of the Bank of England should be made public. Prior to shortlisting they could extend the date, before applications close.

- HMT should provide the TSC with further information about any appointment process upon request.



[83] See: HM Treasury, Bank of England (2017). 'Candidate Brief: Appointment of External Member of the Monetary Policy Committee of the Bank of England'. Accessed on 20/09/2019, available at: https://publicappointments.cabinetoffice.gov.uk/wp-content/uploads/2017/02/MPC-candidate-pack.pdf

Chapter 3:

DIALOGUE AND PARTICIPATION

Bringing in new decision-makers can only go so far towards improving legitimacy. Whatever their identity and background, central bank policymakers operate within a context constrained by their mandate and by the information available to guide their decisions. To assist in this work, it is vital that central banks engage in dialogue with society. This gives policymakers a chance to communicate their point of view to market participants and the wider public. In turn, society should be able to scrutinise the actions of central bankers themselves and feed into their understanding of citizens' lived experience.

Orthodox economics sees central bank communication as a tool to make monetary policy more effective and efficient. Moreover, in a world where market players have rational expectations but imperfect knowledge, communication is thought to help the public and financial markets understand economic variables and the trajectory of interest rates, thus also 'anchoring' inflation expectations. The account given by Blinder *et al.* is typical. It claims central banks can do two things: 'create news' and 'reduce noise'. The former influences intermediate and long-term interest rates by shifting expectations as to future central bank policy. The latter "increases the predictability of central bank actions, which should in turn reduce volatility in financial markets." [84]

However, the case for dialogue that rests on legitimacy concerns goes further. Dialogue should be two-way, with citizens speaking to central bankers as well as central bankers addressing the public. Endless speeches delivered by top central bank officials are not enough. Furthermore, the subject of communication should go beyond just policy content (e.g. the expected level of the policy interest rate) to include evaluation of the effects of policy. A framework for dialogue should also afford room for normative debate, over what the aims and methods of policy ought to be. Importantly, while the neoclassical account focuses on monetary policy, these principles for legitimacy apply in equal measure to central banks' new responsibilities in the area of financial stability.

This chapter first surveys an emergent literature on the open-ended process of dialogue central banks will need to create and nurture to meet these challenges. Second, it examines policies to improve dialogue, including innovations at the Bank of England. Finally, recommendations are made for the Bank to firmly establish meaningful dialogue with society in its practices.

[84] Blinder, A. S., Ehrmann, M., Fratzscher, M., De Haan, K. and Jansen, D. (2008). Central Bank Communication and Monetary Policy: A Survey of Theory and Evidence. NBER Working Paper No. 13932

3.1 Communication with and by central banks

Speaking to an audience in Tallinn, the Chief Economist of the Bank of England, Andy Haldane, argued that "a second revolution in central bank [communication and accountability] practices may be needed... every bit as radical as the first." That revolution, he argued, "would require central banks to engage with, and draw on, the general public – their "folk wisdom" – as never before." [85]

In Haldane's account, the first revolution, which occurred over the decade or so prior to the financial crisis, amounted to a drive to improve the credibility of policy set by an independent central bank. In short, "through greater transparency... policy suspicions among the public could be allayed, thereby helping anchor inflation expectations in the economy." The changes involved in the first revolution have been extensive. Haldane points out that the number of Bank of England appearances before Parliament has risen around 20-fold, the number of publications around 600-fold (including speeches, working papers, consultation documents, blogs, and statistical releases) and the number of words in speeches around 1,000-fold.

The second revolution, by contrast, is about rebuilding the lost trust and improving understanding between central bankers and the public. In part, the need for further changes is based on the recognition that increased communication has done little to familiarise the vast majority of the working public with the role of central banks. Yet it is important to recognise the additional impact of the 2007-08 crisis and the policies adopted to counter it. As has been argued throughout this paper, central banking now finds itself in a dramatically different context to before the crisis. Central banks themselves are aware of these pressures. In a European Central Bank working paper on communication, Coenen *et al*. describe two such changes:

[85] Haldane, A. (2018). Folk Wisdom. Lecture for the Bank of Estonia's 100th Anniversary, Talinn, September 19. Accessed on 20/09/2019, available at: https://www.bankofengland.co.uk/speech/2018/andy-haldane-bank-of-estonia

> **“First, because some of these measures are quasi-fiscal and therefore impose a risk on the taxpayer, and second, because some unconventional tools have more tangible distributional effects, therefore leading to a more prominent discussion of central bank policies in the public discourse.”** [86]

In other words, central banks now have sweeping powers and responsibilities that necessitate strategic thinking about accountability. Old arguments about honing the effectiveness of monetary policy still hold water. But building central banks’ legitimacy provisions is a larger and more urgent task, for the sake of economic and political stability, and effective management of the next crisis.

The new frontier of communication should be seen as an opportunity. In *Financial Citizenship*, Riles identifies substantial accountability gaps and construes them in terms of *culture* as well as governance structures. In her words, “when the gulf between the culture of those who govern and the cultures of the governed becomes unmanageable, the result is a legitimacy crisis.” The recommendations made in this paper concerning appointments to decision-making committees consider the culture problem from one angle. Improving dialogue does so from another: it closes the gap between the governed and those who govern.

The Bank of England has already made some important changes to its communication which recognise this ‘gulf’ in culture. These include a simplified version of the Inflation Report, known as the ‘Visual Summary’, which has been estimated to have increased public understanding of the Report’s key messages.[88] However, the most significant changes move past communication *by* the Bank and consider dialogue and participation *with* the Bank, on the part of the public.

[86] Coenen, G., Ehrmann, M., Gaballo, G., Hoffmann, P., Nakov, A., Nardelli, S., Persson, E. and Strasser, G. (2017). ‘Communication of monetary policy in unconventional times’. European Central Bank Working Paper Series, No. 2080, June, p. 5

[87] Riles, *Financial Citizenship*, p. 3

[88] Bholat, D., Broughton, N., Parker, A., Ter Meer, J. and Walczak, E. (2018). Enhancing central bank communications with behavioural insights. Bank of England Staff Working Paper, No. 750.

3.2 Dialogue with and scrutiny of the Bank of England

Several channels for this sort of engagement already exist. Three innovations are considered here:

1. Improving hearings to allow civil society groups and other economic and social actors to hold senior central bankers to account;
2. Press releases, reports and speeches, with a focus on financial regulation and stability; and
3. Soliciting input to the policymaking process and reflections on its aims and parameters from the public.

Strengthening and deepening these measures – both new and old alike – would do more than act as a bulwark against further erosion of legitimacy. It would also help make the normative judgments required to set a direction for a new model of central banking.

Policy hearings in Parliament

The Treasury Select Committee holds hearings with senior Bank of England officials to scrutinise the Bank's conduct of monetary and financial policy. These take place following the release of an Inflation Report or Financial Stability Report, respectively. A Bruegel report in 2014 described Parliamentary oversight of the Bank of England as more robust than that of the European Central Bank by the European Parliament. The reasons it offers include greater regularity of hearings, extra transparency (in the sense that minutes of committee meetings are soon available), and the potential for sanctions.[89]

However, there is one area in which these hearings could go further towards improving the Bank's legitimacy: allowing academics and civil society organisations an integral role in formal provisions for oversight and scrutiny. Compared to congressional committees in the United States, the TSC receives relatively little technical support for its work.[90] This gap could be filled by a formal process for submission of evidence and questions by academic economists and sociologists, or NGOs.

The TSC's 'inquiries' on the Inflation Report and Financial Stability Report could be improved by this process. Unlike some other Select Committee inquiries, the TSC does not launch a call for submissions or evidence when it holds hearings with the Bank of England officials. On the one hand, there are advantages to a focused hearing which allows the Bank to communicate what it is doing to achieve its objectives. But another consequence is that wider issues are rarely discussed, and the economic paradigm employed by the Bank is hardly challenged. It would make sense for at least some of these inquiries to serve as a more robust test of the Bank's actions. Perhaps once a year (for each of the Inflation Report and Financial Stability Report), the TSC should follow the process for a broader inquiry: receive submissions from wider society, publish them online, and devote a section of the hearing to questions which speak to contemporary issues surrounding monetary or financial policy.

In most instances, the arguments made by NGOs are not in favour of particular interest groups but concern the resilience of the economy and collective prosperity more broadly. In any case, senior Bank staff interact continually with representatives from the private financial sector, simply as a matter of course in their work. Other sections of society should also be able to scrutinise the impact of the Bank's policies. The formal setting of Parliament should remain the prism through which to focus this scrutiny. This would allow NGOs to answer Riles' call:

[89] Claeys, G., Hallerberg, M. and Tschekassin, O. (2014). European Central Bank Accountability: How the Monetary Dialogue could Evolve. Policy Contributions 818, Bruegel. pp. 5-6

[90] Lepper, J. and Sterne, G. (2002). Parliamentary scrutiny of central banks in the United Kingdom and overseas. Bank of England Quarterly Bulletin, Autumn 2002. pp. 278-79

> **"The community... interested in financial governance need to demonstrate their commitment to financial citizenship... to be able to say: "Trust us because we listen carefully. Trust us because when we criticize, it is a place of shared commitment to the resilience of our economy. Trust us because even when we disagree about policy directions, we respect your expertise, your judgment, and your commitment to your task.""** [91]

Stress tests and communicating regulation

Much of the preceding discussion relates to monetary policy, but as Chapter 2 revealed, financial regulation has just as much of a legitimacy problem. Financial regulation is complex and often poorly understood by commentators, let alone members of the general public. Furthermore, the information guiding decisions is often highly sensitive and confidential, such as the financial health (or otherwise) of major institutions. Despite these difficulties, secrecy must not be the default option, as it concentrates power and erodes trust.

To increase transparency in financial regulation, the Bank could build on the practice of stress tests, a primary instrument of financial supervision in recent years. While some such tests were conducted by regulators and within banks themselves prior to the financial crisis, they were insufficiently robust – both in terms of the shocks institutions were subjected to and the predicted losses. Following the crisis, regulatory tests became "large-scale, comprehensive risk-assessment programmes in their own right leading directly to policy responses." The Bank of England began its own programme in 2014. [92]

[91] Financial Citizenship, p. 54

[92] Dent, K., Westwood, B. and Segoviano, M. (2016). 'Stress testing of banks: an introduction'. Bank of England, *Quarterly Bulletin*, Q3, pp. 130-143

Tucker argues that "nothing short of a revolution is needed" when it comes to "public debate and political accountability" concerning central banks' regulatory functions.[93] As discussed in Chapter 1, since prudential regulation is by its very nature sensitive and confidential, the conditions for legitimate independence are unlikely to be met. However, Tucker reasons that the stress test should be front and centre of an effort to make regulation transparent. He writes:

> **"Year by year, everyone will see the severity of the chosen stress scenarios as well as the firm-by-firm results. Legislators will be able to examine regulators on both, drawing on commentary from different parts of the financial system and, just as important, wider society. In time that will be informed by academic research on the effects on market discipline, the relative toughness of different jurisdictions' tests, how well they pinned down vulnerabilities before large losses were incurred, and so on."[94]**

Moreover, the tests have the advantage of making the public aware of the (relative) *presence* of financial stability; normally, society only notices when stability is *absent,* in the form of crises and volatility. However, there are still significant problems. One concern is the asymmetry of expertise about supervision and regulation. Not only are regulatory policymakers at the Bank of England themselves drawn from the financial sector, but the financial lobby, and publications primarily catering to an audience of finance sector professionals, naturally take a disproportionate interest in commenting on the suitability of measures like stress tests. There is no formal process for critics of regulatory measures to voice their concerns and it is difficult for a range of voices to be heard in the media. It seems only influential figures who are already members of the elite (such as John Vickers, a vocal critic of the Bank's tests[95]) are heard.

A second issue is that the timeframe implicit in Tucker's account is extremely long, with a substantial lag before democratic authorities can call faulty regulation to account. It would take several years before mistakes would become visible, over the course of which the effects of overly lax (or strict) regulation would have compounded. The stakes are high: banks and other financial firms are large and profitable businesses, while financial crises have dramatic effects on the wellbeing of millions of citizens. Is the mechanism Tucker proposes really sufficient for democratic legitimacy?

These additional challenges make supplementary measures such as those described above – to bolster the capability of Parliament's Treasury Select Committee to scrutinise Financial Stability Reports – even more important.

[93] Unelected Power, p. 476

[94] Ibid., p. 478

[95] Arnold, M. (2018). 'British banking leverage remains 'dangerously high''. *Financial Times*, May 2. Accessed on 04/04/2019, available at: https://www.ft.com/content/775e3de4-4e1b-11e8-a7a9-37318e776bab

Participatory panels

The most innovative change at the Bank of England in recent years has been the plan to establish 'Citizens' Reference Panels' to contribute to monetary policymaking, following recommendations made by the Royal Society for Arts, Manufactures, and Commerce (RSA) in March 2018.[96]

The Bank already surveys groups of companies to inform monetary policy decisions through its network of Agents. Andy Haldane has run occasional 'Town Hall' sessions to gather similar, qualitative information from citizens. The Panels could go further. Under the RSA proposal, "the Bank's officials would present economic data to panel members, inform them about the Bank's policies, and gather views about how particular policies would affect them." [97]

The aspiration is threefold. First, the quality of policy should improve, as Bank committee members will have superior information about the real economy. Second, by visibly involving citizens in the process, legitimacy will increase: the RSA paper claimed "47 percent of people would trust economic policymaking more if they knew that ordinary citizens had been formally involved in the process." Finally, citizens would increasingly come to possess greater agency over their economic future and prospects. Panels are one innovation considered to lead to a "deeper understanding of problems and solutions that are based on high quality information, respectful debate, and which honours diverse viewpoints, values and experiences."[98]

The proposal has a lot of potential to improve the legitimacy of Bank policymaking by forcing the Bank to communicate what it does in a way that is accessible to the general public, and to be questioned on those terms. The process would be even better if used by the Bank to communicate some of the tensions, challenges and trade-offs it faces with regards to its policy. The content of the Panels should be published and disseminated widely, to sustain a national conversation about the Bank's policy – including in Parliament.

However, it is important to be clear about what the Panels are *not*. All participants in the Panels will have to self-select into the group (and only then filtered to match a societal cross-section),[99] affecting how representative they will really be. It would not be appropriate for the Panels to *make* decisions themselves. Indeed, allowing arbitrary groups of citizens to have concrete influence over the outcome of a policy process would itself be incompatible with democratic representation and legitimacy.

[96] Patel, R., Gibbon, K. and Greenham, T. (2018). Building a Public Culture of Economics. RSA

[97] Ibid., p. 84

[98] Ibid., pp. 78-79

[99] Bank of England (2019). 'Bank of England citizens' panels'. Accessed on 16/04/2019, available at: https://www.bankofengland.co.uk/outreach/citizens-panels

Conclusion: communication by, with, and about the Bank

As many central bank insiders admit, a revolution in communication and engagement is required. The Bank of England should be praised for taking the initiative and becoming 'legitimacy seekers.' [100] That can happen by allowing civil society a regular, established voice in Parliamentary oversight, and by instituting a new role for Citizens' Panels.

However, there is scope to go beyond the narrow conception of communication that makes monetary policy *operation* more effective and legitimate. The legitimacy of a given model of central banking ultimately rests on delegation by its democratic counterpart – the Treasury (HMT). Given that neither Citizens' Panels nor the TSC can properly address the Bank's mandate with democratic legitimacy, a further mechanism is required to raise communication to the level of the *goals and parameters* (rather than simply the *operational detail*) of central bank policy. **HMT must communicate its reasons for retaining the current model, with the same objectives and tools.** The appropriate space for a full discussion over these is Parliament as a whole. In the end, there is only so much that dialogue with the Bank can achieve.

[100] Tucker, Unelected Power. p. 161

Recommendations

- Annually, the TSC should hold Inflation Report and Financial Stability Report 'super' inquiries with greater scope than those held currently. Each should be supported by a call for questions and analysis submitted by civil society organisations and academics. A devoted section of each hearing with senior Bank staff should allow TSC members to address matters surrounding the Bank's operations which are not directly relevant to the remit, such as the impact of policy on inequality or the climate.
- Develop Citizens' Panels where the Bank must explain its policy, including the trade-offs it faces and the choices it has made with respect to those trade-offs and ask for feedback and questioning. Evidence from each annual round of Panels should be an input into the annual TSC 'super' inquiries.
- Annually, HMT should put a report before Parliament presenting its reasoning for retaining the shape of the monetary policy and financial policy remits. The report should refer to contemporary issues which emerge through the TSC's 'super' inquiries.

Chapter 4:

CRISIS MANAGMENT

The exceptionally loose monetary policy stance of central banks in advanced economies over the past decade is partly due to governments' failure to adopt appropriate fiscal policies. Austerity put downward pressure on inflation and led to output persistently below its pre-crisis trend. [101] QE and historically low interest rates were necessary to take up the slack.

The Treasury can and should work with its central bank. This fact was recognised long before the 2007-08 crisis,[102] but has been taken up with renewed vigour since. At the effective lower bound for nominal interest rates, the central bank is simply unable to meet its objectives using conventional policy instruments. Coordination with government is key for monetary policy to stimulate inflation effectively and minimising negative side-effects.[103] Moreover, involving government also improves the democratic legitimacy of decisions, because central bank action can be approved by elected representatives.

However, the nature of financial crises means that more government involvement is no panacea. This is for several reasons. First, emergencies require decisive action, and often democratic procedures are too slow or contested to produce sufficiently bold policies. Secondly, it is difficult, even impossible, to make comprehensive provisions in advance, since each financial crisis unfolds in different ways.[104] Third, and perhaps most importantly, policies required to repair the banking sector involves enormous financial interventions that are poorly communicated and even less well understood by the general public. This applies to the lender-of-last-resort (LOLR) function as well as balance sheet operations.

The challenge, therefore, is to design a crisis response mechanism that is legitimate and effective in equal measure. In other words, government and public oversight must be involved, but in a way that does not render policy ineffective and lead to large welfare losses. Following a survey of policies adopted by the Bank of England during and since the 2007-08 financial crisis, this chapter considers several ways to approach this problem.

[101] Cribb, J. and Johnson, P. (2018) 10 years on - have we recovered from the financial crisis? Institute for Fiscal Studies, September. Accessed on 02/04/2019, available at: https://www.ifs.org.uk/publications/13302

[102] Laurens, B. and de la Piedra, E. G. (1998). 'Coordination of Monetary and Fiscal Policies'. IMF Working Paper, WP/98/25, March

[103] McCulley, P., and Pozser, Z. (2012) 'Does Central Bank Independence Frustrate the Optimal Fiscal-Monetary Policy Mix in a Liquidity Trap?'. Global Society of Fellows, January

[104] This point should not be overstated; there is a large body of work studying common patterns across banking crises. E.g. Mian, A. and Sufi, A. (2013). *House of Debt: How They (and You) Caused the Great Recession, and How We Can Prevent It from Happening Again*. University of Chicago Press

4.1 Bank of England policy during and after the crisis

The UK entered the crisis with an institutional model for managing the financial system strikingly different from the one it knows a decade later. The Financial Services Authority was responsible for regulating the financial sector, while the Bank operated monetary policy. Therefore, while the Bank controlled the monetary response to major bank failures that swept the North Atlantic in 2007-08, it did not receive responsibility for financial regulation until the Financial Services Act 2012 was passed by Parliament. Perhaps as a consequence of the pre-crisis assignment, the Bank's capacity and knowledge on financial stability under the governorship of Mervyn King was deficient.[105]

The crisis claimed its first victim in the form of Northern Rock, a former building society that had grown into a bank around one-twentieth the size of Barclays Bank.[106] The decision over Northern Rock served as an initial test for the UK's crisis management framework. Crucially, the Bank of England did not have a full Discount Window facility through which it could lend to distressed banks in crisis until 2008. While it was still able to provide emergency liquidity assistance (ELA), the lack of a clear, pre-existing procedure for doing so contributed to a loss of confidence in Northern Rock in the eyes of investors and depositors. Reflecting the incoherence of the institutional framework, the response to the Northern Rock failure was uncoordinated and ineffective.[107]

As the crisis intensified, other banks drew on the Bank of England's ELA. The ailing Halifax Bank of Scotland (HBOS) first received ELA on 1 October 2008 and at peak on 13 November had drawn £25.4 billion. It made the final repayment of all drawings in January 2009. Royal Bank of Scotland (RBS) also received ELA in October 2008. Its use of the dollar facility peaked at $25 billion, and of the sterling facility at £29.4 billion. RBS made final repayment of ELA on 16 December 2008.[108]

The experience of ELA demonstrates the scope and scale of financial interventions the Bank is empowered to make. However, the decision to extend the scheme is ultimately the responsibility of the Chancellor. The Bank received an indemnity from HM Treasury (HMT) for any additional amounts drawn after 13 October. Before that indemnity was put in place, the full £51.1 billion of the Bank's exposure at that date was not indemnified. Even after the indemnity was in place, the Bank remained unindemnified for £50.9 billion of its exposures under the scheme. In his review of ELA, commissioned by the Bank, Ian Plendereith suggests that the Bank should seek an indemnity from HMT for the full amount as soon as it seeks authorisation from the Chancellor.[109]

The ELA offered by the Bank raises its own questions of accountability and legitimacy. In effect, large sums of money are passed to private institutions following decisions made behind closed doors. In this case, the only alternative is to risk the collapse of the payments system (part of the solution, discussed later in this paper, lies in reimagining the Bank's wider role). However, the process – hastily reaching agreement between HMT and the Bank, and the convention that the Bank should be indemnified – is mirrored in how the Bank arrived came to adopt QE.

[105] Irwin, N. (2013). *The Alchemists: Inside the Secret World of Central Bankers.* Business Plus. p. 144

[106] Ibid., p. 148

[107] Cunliffe, J. (2017). Ten years on: Lessons from Northern Rock. Speech given at Single Resolution Board Annual Conference, Brussels, September 29. Accessed on 20/09/2019, available at: https://www.bankofengland.co.uk/speech/2017/ten-years-on-lessons-from-northern-rock-speech-by-jon-cunliffe

[108] Plendereith, I. (2012). Provision of Emergency Liquidity Assistance in 2008-09. Report Presented to the Court of the Bank of England, October

[109] Ibid., p. 10

Monetary policy

As well as providing vast sums in liquidity assistance directly to banks, the Bank of England also undertook further financial support through its Asset Purchase Facility (APF), launched in 2009. The then Chancellor of the Exchequer, Alistair Darling, granted the APF permission for £50 billion in purchases of government bonds, and also stated that “the Government will not alter its issuance strategy as a result of asset transactions undertaken by the Bank of England for monetary policy purposes.”[110] In the case of the APF, the Treasury indemnified the Bank for the initial £50 billion of purchases in January 2009. The decision to make the first purchases using the Facility was made by the MPC in its February 2009 meeting.

Large-scale interventions using the Bank’s balance sheet aren’t necessarily incompatible with legitimacy under central bank independence. The question is how the scheme is designed. As Tucker writes, “suspicions are more readily assuaged if the need for coordination with government has been countenanced and telegraphed in advance.” He claims that this was achieved in the case of the UK through speeches made by MPC members, including the Governor.[111]

A common theme between the Bank’s ELA and the decisions behind QE is that HMT is implicated in emergency measures from the start, whether they are aimed at providing support to banks or to the economy more broadly. The notion that the central bank is able to control the financial and economic system in total isolation from HMT is a mirage. However, what is clear is that both policy tools were created under what might be described as ‘minimalist’ coordination between the two institutions. This is less surprising in the case of ELA, which the Bank is uniquely equipped to provide, than the APF. The latter represented a break with monetary policy orthodoxy and inaugurated a new, politically controversial instrument in the monetary policy toolkit.

Nevertheless, the Treasury made no move to specify the nature of the asset purchases that should be undertaken. Moreover, from the start, Darling’s assurances ruled out adjusting fiscal policy (and government debt issuance) *in concert* with the Bank’s purchases to make the most of cheaper borrowing. Admittedly, this was consistent with the mandate for the Debt Management Office (DMO) was to “minimise costs of meeting govt financing needs… *while ensuring that debt management policy* is consistent with the aims of monetary policy [emphasis added].”[112] Yet the decision, which set a soft precedent on the removal of QE from political influence, was based on the artificial separation of the day-to-day operation of monetary policy from other government economic policy. As discussed in Chapter 1, that principle was originally conceived when monetary policy meant setting interest rates.

The path of fiscal policy following 2010 was retrogressive in the context of a young and fragile economic recovery. The economy therefore relied even more on monetary support to achieve any growth. The authorised volume of sovereign bond purchases was raised to £200 billion by November 2009,[113] and by July 2012 had been raised to £375 billion.[114] Ultimately, the Facility expanded to £445 billion of purchased securities and £127 billion in loans under the Term Funding Scheme (see Box 5). QE therefore transitioned from a policy born during crisis into a regular monetary policy tool. Channels for holding officials accountable for its use have not been updated to reflect this, despite the fact that the 2007-08 crash was an extraordinary event with unique implications for accountability and legitimacy.

[110] Darling, A. (2009). Letter to Governor King, 3 March 2009. Accessed on 03/04/2019, available at:https://www.bankofengland.co.uk/letter/2009/apf-letter-march-2009

[111] Unelected Power, p. 493

[112] HM Treasury and Bank of England (1995). Report of the Debt Management Review. July

[113] HM Treasury, Bank of England (2009). Exchange of letters regarding extending Asset Purchase Facility - November 2009. Accessed on 20/09/2019, available at: https://www.bankofengland.co.uk/letter/2009/extending-apf-letter-november-2009

[114] Bank of England Asset Purchase Facility Fund Limited (2013). Annual Report 2012/13. p. 1

Box 5: The Bank of England's 2016 QE decision – the Corporate Bond Purchase Scheme and Term Funding Scheme

Once established, the APF became a regular monetary policy tool that the Bank could deploy with relative ease. That meant policymakers turned to it again in 2016, when policymakers became concerned about headwinds to the UK economy following the referendum on Britain's membership of the European Union. In this instance, as well as cutting Bank Rate by 0.25 percentage points (to 0.25 per cent), authorisation from the government was given for £70 billion of new purchases. For the first time, up to £10 billion of that total could be purchases of corporate bonds.

The same MPC meeting also produced a separate instrument, the Term Funding Scheme (TFS), also run through the Asset Purchase Facility. The TFS was designed to extend low-cost credit to UK banks in order to increase the flow of loans to the real economy and thereby strengthen the transmission of the cut in Bank Rate. Over the whole period during which it was operational, banks and building societies borrowed £127 billion. In order to achieve its objectives, the fee that TFS participants paid on these loans was tied to the growth rate of their lending to households and businesses.[115]

An important issue in the case of the CPBS concerns the design of eligibility criteria for the selection of securities to purchase. Research has shown that the purchases are skewed towards high-carbon sectors compared to those sectors' contribution to the economy, simply because of the shape of the corporate bond market.[116] Similarly, the TFS takes for granted that increasing bank lending is an effective way to reach the Bank's objectives. Yet changes in mortgage rates form the main piece of evidence presented to demonstrate its success, even though mortgage lending is less effective at stimulating real economic activity than loans to businesses.[117] The TFS also grants banks funding at concessionary prices (notwithstanding the penalty fee), with consequences for the allocation of new public money. This fact makes the Bank's description of the instrument as simply improving the transmission mechanism somewhat disingenuous.

These unconventional monetary policy instruments raise questions over how the Bank should aim at 'neutrality' with respect to financial markets and the economic system, or if 'neutrality' is even an attainable goal. Both schemes saw the Bank of England create a significant amount of new reserves in order to stimulate economic activity. Both reflect problems and biases inherent in the current financial system. Evaluation of such policies by the standards of that same system obscures wider problems with the Bank's interventions.

[115] Nardi, B.G. and Nwankwo, C. (2018). 'The Term Funding Scheme: design, operation and impact'. Bank of England, *Quarterly Bulletin,* Q4, pp. 1-8

[116] Matikainen, S., Campiglio, E., and Zenghelis, D. (2017). The climate impact of quantitative easing. Grantham Research Institute on Climate Change and the Environment, May

[117] Nardi and Nwankwo (2018). p. 6

4.2 Themes for greater accountability

The UK needs a framework whereby fiscal and monetary authorities are empowered to coordinate more effectively during crisis while avoiding the contradictory stance seen since 2010. However, new tools and relationships created during crisis must be subject to review to preserve accountability.

Transparency over crisis mechanisms

The most basic observation is that crisis management has not been entirely transparent, considering the scale of the financial intervention. For its part, the Bank has made respectable efforts towards transparency. For instance, the transcripts of meetings of the Court of Directors during the crisis period of 2007-09 were released upon request by the Treasury Select Committee.[118] However, there has been some confusion in wider political society as to which institution bears responsibility for QE. As a monetary policy tool, asset purchases are apparently within the sole remit of the MPC. Yet the Bank was indemnified by the Treasury for liabilities incurred through the Facility, and the plans required the Chancellor's authorisation, seemingly shifting responsibility to the government. It is vital, then, that the convention of independence does not prevent the government from living up to that responsibility.

Since the crisis, the Bank of England and HMT have produced a "Memorandum of Understanding on resolution planning and financial crisis management'. That document spelled out the responsibilities assigned to each institution. Importantly, while the Bank has 'primary operational responsibility' for financial crisis management, the Bank must trigger Treasury involvement in decision-making if it believes that there is a material risk to public funds. In such a situation, with either a serious threat to financial stability or pre-commitment of public funds to avert such a threat, the Chancellor is able to use powers to direct the Bank. The Chancellor and Treasury are also responsible for explaining developments to Parliament and the public.[119]

Therefore, it is incumbent on a Chancellor to make absolutely clear in the public sphere both what they understand the MPC will do to tackle a crisis, but also why the Chancellor deems alternative action inappropriate. In crises with public funds at risk (as they presumably will be in the event of a balance sheet intervention), the Bank's operational independence should not be a shield behind which the government can duck responsibility.

[118] Warsh, Transparency and Accountability at the Bank of England, p. 4

[119] HM Treasury (2017). Memorandum of Understanding on resolution planning and financial crisis management. October

Greater fiscal-monetary alignment

As discussed, Treasury involvement during and after the 2007-08 crisis was minimal. The crisis was not considered an opportunity to reach an optimal fiscal-monetary combination over the medium-term. It is important to recognise that the 2010 election brought a new government to power with a new democratic mandate, which would legitimate a change in fiscal policy. However, the election was fought by the Conservative Party on a misguided economic narrative which prioritised fiscal austerity.[120] This has been described as government displaying 'surplus bias'.

A variety of proposals for reform of the UK's macroeconomic framework have emerged. In particular, a proposal by Stirling describes several fiscal rules to constrain governments during economic booms, but which can also mitigate surplus bias. The latter is achieved by an 'investment spending rule', but also a 'fiscal and monetary policy coordination rule, meaning that rules specifying a target for government debt can be suspended temporarily at the request of the Bank of England's MPC, when it judges that monetary policy is constrained by the effective lower bound.[121]

This paper takes no position on the content of particular fiscal rules, but does support establishing a mechanism for the MPC to comment on the government's fiscal stance. One negative consequence of operational independence is that the economic expertise gathered on the Bank's MPC goes untapped, in the sense that senior officials avoid commenting on fiscal policy for fear of overstepping their mandates as unelected policymakers. The Chancellor could grant a legal exemption to this in the Monetary Policy Remit, applicable under clearly defined economic conditions – or indeed when the MPC deems the effective lower-bound to have been reached. That could allow the MPC, as a collective, to write an open letter to the Chancellor seeking clarification of any concerns they have, in making their decision, as to the likely path of the fiscal deficit over a certain period (such as 3 years, the time frame over which monetary policy is considered to be effective). Importantly, the Bank view on fiscal policy would likely influence public debate, countering deficit and surplus bias alike.

[120] See e.g. Gamble, A. (2015). Austerity as Statecraft. *Parliamentary Affairs*, 68, 1, pp. 42–57

[121] Stirling (2018). Just About Managing Demand: Reforming the UK's macroeconomic policy framework. Institute for Public Policy Research, April

UNDERGROUND

Evaluation of policies against alternatives

Finally, the experience of QE and the Bank's liquidity assistance show how rapidly emergency policies must be assembled and deployed. When those policies are innovative and responsive to particular conditions of a given crisis, it is highly plausible that their design will not be optimal. Moreover, there are good reasons to expect similar innovation may be required during the next (with crises occurring on average once every 10 to 15 years[122]). If democratic legitimacy is hard to achieve *during* crisis, a full review of crisis management *in retrospect* is crucial – both in order to learn economic lessons and provide greater accountability.

Concerning liquidity assistance, the Bank of England undertook quite substantial reviews of its policy. Three reviews were commissioned by the Court of the Bank in May 2012, covering aspects of the Bank's performance and capabilities. Two of these concerned the provision of emergency liquidity assistance and the Bank's framework for providing liquidity as a whole. In the realm of monetary policy, the government's main response took the form of a 'Review of the Monetary Policy Framework' in 2013. However, policies like QE and the Term Funding Scheme have not received the full degree of scrutiny warranted by the scale and nature of the intervention.

Outstanding criticisms of QE, including distributional and environmental concerns (see Box 1 in Chapter 1, and Box 5 above in this Chapter) should not be ignored because they lie outside the Bank's remit. On the contrary, the few years of (relative) economic stability following a crisis are an opportunity to assess policies hastily assembled in the heat of crisis, with the benefit of hindsight. QE should be subject to a comprehensive independent review, with the aim of *improving* any future interventions. Such a review should explicitly consider alternative options for policy and their likely effects. It should mark the start of an approach to *ex post* accountability and learning, whereby an independent review of monetary policy during crisis takes place automatically after a fixed period.

[122] Ibid., p. 5

Conclusion: crisis and adaptation

The crisis created many of the Bank's policies and actions that seem most troubling from an accountability perspective. Changes to the institutional framework for managing the financial system have concentrated power at the Bank of England.

Policymakers should strive for a common understanding over the most appropriate course of action in preparation for the next downturn. This process should engage the public and be as transparent as possible. The Bank of England and HMT have made some progress. **Procedures for Bank officials to indicate their expectations about fiscal policy** (from the perspective of macroeconomic stabilisation) would also help.

Central banks' role as a lender of last resort (LOLR) to commercial banks is necessary and justified in the narrow context of a crisis already unfolding. The alternative – failure of the payments system and an enormous loss of income – is too severe. Similarly, asset purchases were deemed necessary to prevent a deflationary spiral. However, QE has become a regular feature of the monetary policy toolkit, without a serious re-evaluation of how officials are held accountable for its use. That is neither necessary nor democratic. For legitimacy to survive the stresses and innovations of a crisis, it is crucial to assess **the decisions taken critically and openly *after the crisis has subsided.***

Moreover, it is important to keep in mind the consequences of central banks painting themselves as guardians of an inherently unstable system. An open consultation on the Bank's market operations in 2008 noted that liquidity provision to reduce social costs in crisis "must be balanced against the incentives for banks to manage the risk of the liquidity of their own balance sheets less carefully in future as a result of that provision."[123] This approach to the problem of moral hazard inherent in the money and banking system is unimaginative: **it merely accepts the presence of the trade-off, and gives an independent Bank little guidance on how to strike the right balance from society's perspective.** That almost guarantees a situation where the Bank's legitimacy is called into question.

New monetary policy tools and the Bank's stewardship of the financial system should be inherently *adaptive*. Following a serious crisis or change, government and the Bank should openly consider alternative approaches to making policy. What alternative role could the Bank of England play in the financial and economic system, while remaining democratically legitimate? The final chapter moves towards an answer to this question.

[123] Bank of England (2008) The Development of the Bank of England's Market Operations. Consultative paper. The same points, and several related trade-offs, are discussed in a Bank for International Settlements paper reviewing the UK's experience: Hauser, A. (2014). 'Lender of last resort operations during the financial crisis: seven practical lessons from the United Kingdom'. In *Re-thinking the lender of last resort,* BIS Papers No 79

Recommendations

- When the effective lower bound has been reached, Bank of England MPC should be entitled to submit a letter to the Chancellor outlining their assumptions for the path of fiscal policy for up to 3 fiscal years.
- Following a crisis, an independent review into monetary policy strategies used or launched during crisis management should be established by the Chancellor of the Exchequer. The Treasury Select Committee can call on the Chancellor to launch such a review 5 years or the length of one Parliament (whichever is sooner) following a recession of significant magnitude. The terms of reference for these reviews should include a requirement to compare the actual policy choice with viable alternatives, not only the status quo.

Chapter 5:

CREDIT POLICY

The previous chapters seek ways to expand and reinforce provisions for accountability and legitimacy mostly *within* the current framework of the Bank of England's independence. These are not the whole story. Getting into the details of questions over accountability and legitimacy naturally throws up questions of what a central bank is for. The pre-crisis model of central banking collapsed in 2007-08; a decade later, there is still controversy over what should replace it.

Some efforts have been made to consider a new model. For instance, Ed Balls – former Shadow Chancellor of the Exchequer and one of the architects of the Bank of England Act – co-authored a study which inspected all of central banks' current functions and made recommendations for some new conventions and practices.[124] However, work of this sort tends to be unambitious when it comes to projecting what a central bank *could* and *should* do, instead re-formulating what it already does.

The era of independence has seen finance ministries step aside and leave lots of the work to central banks. The consequence is that both types of institution seek to pass the blame for adverse economic and social outcomes to the other: the Treasury claims that monetary policy, and more recently financial stability, is and should remain outside of its control, while the Bank refuses to engage on issues outside its mandate.

Because of this, the UK's economic policy framework lacks a full appreciation of the importance of the distribution of credit in the economy. The Bank of England has several levers which influence where credit is allocated, such as its collateral framework and refinancing operations. Because of its mandate, it is unable to align these levers with broader social and economic objectives. The Treasury ignores the question of where credit is allocated, because the tools to influence it sit under the control of the Bank of England. However, **bank lending and systemic factors within the money and banking system are a source of endemic financial instability, economic stagnation, and inequality.** The role of a central bank ought to include addressing these issues.

The discussion at the end of Chapter 4 speaks to a recurrent problem throughout this paper: is it possible for the Bank of England to have sole responsibility and increased powers to pursue financial stability, and still remain democratically legitimate? There are narrow criteria for membership of the decision-making committees handling financial regulation, in terms of experience and knowledge. Regulation and supervision is complex and often market-sensitive, making it hard to communicate to the public. And resolution measures for failed banks during a crisis need to be implemented faster than democratic mechanisms can allow. This chapter seeks a way out of the conundrum with a proposal for credit policy under democratic control.

[124] Balls, E., Howat, J. and Stansbury, A. (2017). Central Bank Independence Revisited: After the financial crisis, what should a model central bank look like? John F. Kennedy School of Government & Economics Department, Harvard University, September

5.1 Breaking free from the independence trap

The role played by central banks in national economic development has been fluid over recent decades. For instance, Ryan-Collins & van Lerven examine the historical evidence on fiscal-monetary coordination. Far from being an immutable law of sound economic policy, the taboo on governmental use of the central bank's balance sheet to facilitate spending is relatively novel. As they argue, 'for a large and economically successful period of the 20th century (1930-1970), monetary financing in various guises was an integral aspect of macroeconomic policy.'

Powerful critiques of a close-minded approach to central bank independence can be found long before the financial crisis occurred. Stiglitz offered the remarks referenced in chapter 1 in 1997, the same year the Bank of England gained independence. In 2002, Kathleen McNamara contested the 'conventional' wisdom that "central bank independence is a necessary solution to a functional economic policy problem," arguing instead that "governments choose to delegate… because delegation has important legitimising and symbolic properties."[125] In other words, central bank independence is a social arrangement that can be changed, as it has in the past. If tweaks to the framework have a clear economic rationale, they should receive full consideration.

The case for credit policy

There is a clear economic rationale for aiming to influence the distribution of bank lending in the economy. Indeed, the blind spot over credit was chiefly responsible for the build up of pressures that caused the financial crisis. Adair Turner, former Chair of the Financial Services Authority (the pre-crisis financial regulator in the UK), has claimed that "the financial crisis… occurred because we failed to constrain the private financial system's creation of private credit and money." [126]

It is not money creation *per se* but rather the sorts of activity which banks lend to that creates instability. In 2018, almost 50 per cent of the outstanding stock of loans were mortgages, while another 26 per cent were loans to the financial sector. Lending to businesses which produce 'real' goods and services constituted only 16 percent of outstanding loans.[127] However, as Bezemer *et al.* note, it is the latter – the share of non-financial business credit – which is the "key banking sector activity for supporting income growth." [128] (The authors also survey a wide range of evidence linking credit allocation to inequalities of wealth and income.)

In the past, central banks have used a wide range of instruments for credit guidance, including credit ceilings and quotas, interest rate ceilings, collateral requirements, and targeted refinancing operations (like the Term Funding Scheme). Bezemer *et al.* show that the use of some of these tools is significantly associated with a higher share of non-financial business credit; others (such as credit ceilings) mainly dampen lending in a particular sector (such as mortgages) without spillover effects for business lending.[129] Therefore, the Bank of England clearly possesses the tools to influence the flow of credit to certain parts of the UK economy.

[125] McNamara, K. (2002). 'Rational Fictions: Central Bank Independence and the Social Logic of Delegation'. *West European Politics*, Vol. 25, No. 1. pp. 47-48

[126] Turner, A. (2012). 'Monetary and Financial Stability: Lessons from the Crisis and from classic economics texts'. Speech at South African Reserve Bank, November 2. p. 19

[127] Bank of England (2018). Bankstats tables. Accessed on 08/04/2019, available at: https://www.bankofengland.co.uk/statistics/tables

[128] Bezemer, D., Ryan-Collins, J., van Lerven, F. and Zhang, L. (2018). Credit where it's due: A historical, theoretical and empirical review of credit guidance policies in the 20th century. Working paper 11, Institute for Innovation and Public Purpose, December. p. 4.

[129] Ibid.

There *has* been some recognition of the importance of bank credit and of certain types of lending since the crisis. Several central banks have adopted macroprudential policy, defined by Baker as "a series of policy interventions in financial and credit markets, comprising a variety of largely untested countercyclical stabilisation techniques that are designed to influence price formation and/or direct credit and investment flows away from certain areas into other areas."[130] Macroprudential policy therefore shares some similarities with credit policy. However, the key difference is the objective. Macroprudential is entirely about financial stability. Recognising that a build-up of risk among individual financial institutions can have potentially systemic consequences, policymakers use novel tools to control and limit those risks. In the case of the Bank of England, the Financial Policy Committee is tasked with monitoring and mitigating potentially systemic risks.

As stressed throughout this paper, the turn to macroprudential policy is one part of a definitive break with the model of central bank independence theorised by academic economists in the late twentieth century. That model's inability to properly promote stable financial conditions has since become commonly accepted among policymakers; **the question now posed is whether monetary policy can make *any* contribution to preserving financial stability.**[131]

Clearly, however, the macroprudential turn has not solved the central banks' legitimacy crisis. If anything, it appears to have worsened in some areas. As central banks move to adopt tighter and more precise controls on the financial system (such as controlling loan-to-value and loan-to-income ratios on mortgage lending), the worry that they are overreaching becomes more acute. In Goodhart & Lastra's terminology (cited in Chapter 1), some such policies have significant directional (i.e. sectoral) and distributional effects – as seen in the European debate over differentiated capital requirements and 'green' lending.[132] Yet as central banks resist demands to pursue other goals in the name of financial stability, macroprudential policy becomes inherently reactive – propping up the current system rather than reshaping it to meet wider social and economic priorities. Baker writes:

> **"Functioning macroprudential regulation is about executing a technocratic control project that rests on a depoliticisation strategy, that in turn risks politicising central banks, exposing their claims to technical authority to critical scrutiny and potential political backlash."[133]**

In other words, macroprudential policy creates a dilemma. The Bank, though now openly concerned with the distribution of bank lending, still ignores the wider societal objectives that it could achieve using its macroprudential toolkit. It faces two contradictory demands from society at large: on the one hand, to expand the purview of its operations; on the other, to retreat from territory where it has no legitimate place.

[130] Baker, A. (2015). The Bankers' Paradox: The Political Economy of Macroprudential Regulation. Systemic Risk Centre Discussion Paper No. 37, April. p. 2

[131] See e.g. IMF (2015). Monetary Policy and Financial Stability. IMF Staff Report, August; Smets, F. (2013). Financial Stability and Monetary Policy: How Closely Interlinked? Conference on "Two Decades of Inflation Targeting: Main Lessons and Remaining Challenges", Riksbank, June

[132] Brunsden, J. (2018). Brussels looks at easing bank capital rules to spur green investment. *Financial Times*, January 2. Accessed on 08/04/2019, available at: https://www.ft.com/content/40df2780-e708-11e7-97e2-916d4fbac0da; Campiglio, E., Dafermos, Y., Monnin, P., Ryan-Collins, J., Schotten, G. & Tanaka, M. (2018). Climate change challenges for central banks and financial regulators. Nature Climate Change, 8(6), pp. 462–468.

[133] The Banker's Paradox, p. 1

An active credit policy linked to an elected government's objectives would be a way out. Instead of gathering any number of considerations, from inequality to climate change, under the rubric of financial stability, a better approach would make these objectives explicit. However, credit guidance policies have distributional and directional effects. Moreover, the goals of such a policy are likely to fluctuate as different priorities for the purpose of the financial system come to the fore, as illustrated by the debate over sustainable finance. In other words, credit policy fails at least one of the crucial assumptions for legitimate delegation to an independent authority discussed in Chapter 1. It would therefore have to remain under the control of democratically elected policymakers, and the departments they lead – in other words, the Treasury.

5.2 Framework, not objective

The case for credit policy has recently been expressed as a complaint over the UK's struggle to achieve strong growth in labour productivity. Notably, a report by GFC Economics and Clearpoint Advisors, commissioned by the British Labour Party, linked poor growth in productivity to a skew in lending by the banking sector away from productive investment. The report recommended expanding the Bank's toolkit to include credit guidance, with the use of that new tool to be informed by a new objective in the Bank's mandate: to achieve a 3 per cent growth in productivity each year. That contrasts with a trend of 2.3 per cent growth between 1980 and 2008, and 0.5 per cent since the crisis.[134]

While the report rightly called for a detailed analysis of lending and productive investment as a starting point for any effective, progressive economic strategy, relying on a new objective to incorporate it into the Bank's work is a wrong turn. Firstly, it is unclear how any conflict with the Bank's price stability objective would be resolved. Secondly, as this paper has addressed, **targets create blind spots.** Aiming for a particular productivity target is one valid rationale for credit guidance, but not the only reason. It would be hard for an institution aiming for such a high growth rate to pay due consideration to other variables. Thirdly, while finance and credit affect productivity growth, it isn't certain that the Bank could achieve the target, even with an expanded toolkit. When questioned by the Treasury Select Committee over what they would do to meet a hypothetical productivity growth target, officials from the MPC noted that monetary tools would be unlikely to have a material effect over short time horizons.[135]

Therefore, instead of a new objective for the Bank, a strong case emerges for a new form of deep cooperation between the Bank of England and the Treasury. Democratically accountable decision-makers would set objectives *and make some operational decisions*, while the Bank would carry out and implement policy. Therefore credit policy could be implemented without interfering with operational independence.

Examples of objectives for credit policy might be "to grow priority sectors, to finance innovation, to reach small businesses or farms, or to decrease consumption and mortgage lending."[136] As the GFC/Clearpoint report makes clear, these objectives can and should be linked to the broader concept of 'industrial strategy' (even contributing to particular 'missions' within a broader strategy[137]). This approach to economic policymaking has enjoyed a recent return to popularity. In the UK, that manifested in the creation of the Department for Business, Energy and Industrial Strategy (BEIS), which published the government's first white paper on the subject in late 2017.[138] The government has already recognised the importance of monetary and financial dynamics in this field, by bringing the Bank's Chief Economist Andy Haldane to chair the board of a recently established Industrial Strategy Council. The (independent) Council will be tasked with "holding the government to account by monitoring its success delivering the Industrial Strategy and its impact on the economy."[139]

[134] Giles, C. (2018). Britain's productivity crisis in eight charts. *Financial Times*, August 18. Accessed on 08/04/2019, available at: https://www.ft.com/content/6ada0002-9a57-11e8-9702-5946bae86e6d

[135] House of Commons (2018). Treasury Committee Oral evidence: Bank of England inflation reports, HC 596. September 4. Accessed on 08/04/2019. Available at: http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/bank-of-england-inflation-reports/oral/88624.pdf

[136] Bezemer *et al*., p. 12

[137] For an account of this sort of policymaking, see Kattel, R., Mazzucato, M., Ryan-Collins, J., and Sharpe, S. (2018). The economics of change: Policy and appraisal for missions, market shaping and public purpose. Working paper 06, Institute for Innovation and Public Purpose, July

[138] Department for Business, Energy & Industrial Strategy (2017). Industrial Strategy: building a Britain fit for the future. November

[139] HM Treasury & Department for Business, Energy & Industrial Strategy (2018). 'Chair of new Industrial Strategy Council appointed'. October 8. Accessed on 09/04/2019, available at: https://www.gov.uk/government/news/chair-of-new-industrial-strategy-council-appointed

In short, the institutional framework for managing the UK's industrial strategy is still nascent. It would be entirely possible to integrate a policy unit for credit guidance into this framework. That unit would then pursue objectives set by the government under the wider industrial strategy – for instance, aiming at a growth rate for credit to sectors below a certain threshold for CO_2 emissions. Some macroprudential functions which have distributional consequences could be integrated into this new unit, with the Financial Policy Committee retaining responsibility for the rest.

How to assign roles within this new credit policy architecture should be the subject of a comprehensive commission launched by the Treasury, with submissions from BEIS and the Bank of England, as well as external experts. Economic questions will be relevant, such as the effectiveness of particular tools and the growth potential for certain industries. So too will the subject of this paper: how to render this new function for the Bank of England in a way that is accountable and democratically legitimate. Table 1 presents one possible configuration.

Institution	Role
BEIS	Set key objectives, such as sectoral targets for lending or growth, within the rubric of the government's overall Industrial Strategy
HMT	Direct the Bank of England on the use of credit guidance tools to achieve objectives as set by BEIS.
Bank of England - Prudential Regulation Authority	Operate credit guidance policies as directed by HMT
Bank of England - Financial Policy Committee	Advise HMT on expectations for macroprudential policy and the consequences of credit policy goals for financial stability

Table 1: Potential configuration of responsibilities for a credit policy in the UK

An arrangement of this sort would confer democratic legitimacy on credit guidance by returning responsibility to the Treasury, in coordination with other departments in central government. The Bank's mandate for price and financial stability would remain, but the Bank would no longer be the only entity shaping the financial sector. The Financial Policy Committee should be permitted to comment on the objectives of the credit policy unit, to ensure they are consistent with macroprudential efforts. Again, the precise mechanism for how to achieve this consistency will be contested and should be part of the terms of reference for the commission.

Recommendation

- HM Treasury and the Department for Business, Energy and Industrial Strategy should jointly establish a commission to design a framework for credit policy in the UK. Both departments and the Bank of England should be represented on the commission, but a majority should be external representatives. The terms of reference should include:
    - Which credit guidance tools and instruments are most effective and would best allow the government to achieve certain objectives?
    - How should the Bank of England report on its implementation of the Treasury's objectives for credit policy?
    - Would the operation of a credit policy come into conflict with the Bank's monetary policy objectives, and how can this conflict be managed?
    - What would be the optimal relationship between the Financial Policy Committee and a body within HMT setting priorities for credit policy?

Conclusion:
Towards a New Settlement

The financial crisis revealed a substantial gap between reality and the orthodox economic theory of central bank independence. The most serious issues pre-date the crisis, which simply cast them in a harsher light. Central bank policies can have distributional effects, across both individuals and sectors. The tools of monetary policy are caught between impotence (Bank rate) and heightened controversy over unintended consequences (quantitative easing). The choice of a 2 per cent inflation target, yet no primary objective for employment, is more a product of academic and policy inertia than of social consensus. And the financial stability objective is far from a clear, measurable target prized by the literature on delegation.

That gap between theory and reality has led to a profound erosion of trust in governing institutions across Western economies. Although the Bank of England has made some important changes to the way it gathers information and presents its policy to the public, the fundamental characteristics of its mandate and relationship to the Treasury still present some serious problems for accountability and democratic legitimacy. Importantly, QE was allowed to become a garden-variety monetary policy instrument without strengthening how the Bank's officials are held accountable for the vast financial interventions it has undertaken.

Moreover, macroprudential regulation and the Bank's role as lender-of-last-resort are to some extent conservative responses to the problem of financial instability. The money and banking system in the UK results in a heavy skew in newly created credit towards mortgage and intra-financial sector lending. It produces a debt-driven economy that is a source of endemic instability. Correcting it requires more active stewardship of the financial system.

To address the Bank's imperilled legitimacy, this paper has presented changes ranging from small modifications to a substantial overhaul of part of the Bank's work. Table 2 presents these alongside the area of the Bank's policy or governance they refer to.

Area	Proposal
Appointment processes	Alter job descriptions when seeking appointees to the MPC in order to welcome applicants from civil society or trade unions.
	Allow the Treasury Select Committee (TSC) to see a shortlist of candidates and provide feedback to the Chancellor and the Treasury as to where they could promote greater diversity.
	Make the shortlist for any new Governor public.
Policy hearings in Parliament	Supplement the Inflation Report and Financial Stability Report inquiries conducted by the TSC with evidence from a board of independent academics and civil society representatives.
Citizens' Reference Panels	Formalise the process of holding Panels nationwide over extended periods of several months. After a fixed period (e.g. a decade), evidence from the Panels will contribute to a debate in Parliament on the terms of the mandate.
Coordination between HMT and the Bank	Following a crisis, an independent review into monetary policy strategies used or launched during crisis management should take place.
	When interest rates are at the effective lower-bound, enable the MPC to write an open letter to the Chancellor with their expectations or assumptions over fiscal policy.
Credit policy	Install a new unit split across the Bank of England and HMT. The Bank should operate credit guidance instruments as directed by HMT, which in turn receives goals and objectives from the Industrial Strategy set within BEIS.

Table 2: Recommendations, by area of Bank of England activity

Taken as a whole, this set of changes would improve channels of accountability between the Bank and the public (either directly, or via the public's representatives in Parliament). The new framework proposed here would recognise that the Bank's operational independence is never absolute and always a matter of degree. It would constitute a new settlement for the Bank – one that is open and adaptive, rather than defensive and static. While no institution or framework is ever guaranteed the public's trust, central banks must move to *seek legitimacy,* rather than assuming it has been conferred on them by outdated mechanisms. They have begun to do so, but to go the full distance, Parliament and Government must lead the way.

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