Should the Bank of England remain independent?

By Gerard Lyons
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In 1999 a House of Lords Select Committee under Professor Lord Maurice Peston produced an excellent report on the Bank of England.

I testified to that Committee and my comments figured prominently in the final report. One of the many concerns, even back then, was over the Bank of England's accountability and governance. It is interesting to note that some of the recommendations of that Lords Committee are now being taken into account, one example being that the next Governor will serve a single, eight-year term.

In the wake of the financial crisis, what are the economic issues that are now centre stage for the Bank of England?

One question that is never asked, but now should be, is whether the Bank should remain independent. The answer should probably be "yes" but it is not clear-cut. In asking the question, the focus of attention turns to a core issue: increasingly the powers of the central bank are moving outside of traditional monetary policy.

Many factors caused the crisis. A contributory one was the narrow focus of central banks in the West on consumer price inflation, without sufficient regard for other developments. In the UK, the surge in house-price inflation, excesses in the financial system and economic imbalances were part of those developments. As the crisis has shown, the future remit and the toolkit for the Bank of England now has to be larger.

A big challenge for an independent central bank – and not just here – used to be the relationship between monetary and fiscal policy. There was always the need for consistency between the two. Thus, in recent years, a tougher fiscal stance and an economy in recession has meant a looser monetary policy. This does not prevent the Governor from commenting on fiscal policy as he did last week, making the sensible suggestion that the Chancellor delay hitting his self-imposed rule of reducing the UK's level of debt, rather than tighten further.

Now, life has become more complicated for the Bank of England. It is being entrusted with new and greater economic powers. Financial stability has joined low inflation as its focus. The new Financial Policy Committee will oversee this.

The challenge is that, as the Bank of England itself stated, "excessive credit expansion, often in the real-estate sector, has characterised the build-up to crises in the past, from the Great Depression". Basically, every time the economy gets into trouble, one of the causes, and one of the best indicators of problems to come, has been rising house-price inflation.

The policy toolkit is thus being enlarged to include macro-prudential measures. Where used in other countries, these measures have been simple and direct, often focused on preventing a property boom. These new policies will take the Bank increasingly into fiscal policy and also, in my view, into social policy.

Successful macro-prudential policies have sometimes required curbing the demand for properties by preventing people gaining access to finance and have even required governments to increase the supply of housing. Thus, the new policies will work best when co-ordinated with other areas of policy outside the remit of the central bank. The implication is the need for close future co-ordination between Threadneedle Street and Downing Street.

It is still unclear how the newly enlarged Bank will work. What is the relationship between the new Financial Policy Committee and the existing Monetary Policy Committee? Clearly there will be feedback loops in that the policies of one will have bearings on the other. Also, how will the need to curb the housing market go down in Westminster and with the general public?

Communication of policy is ever more important, so people can understand its implications. This would be helped by making policy as simple and as effective as possible.

Andy Haldane, the Bank's head of financial stability, recently talked about the need to remove complexity from bank regulation. In terms of regulation, one worry is that increased capital and liquidity requirements could have the unintended policy consequence of limiting lending. Another is that it could force business towards the unregulated shadow-banking industry.

A perennial problem in the UK has been the difficulty of financing small businesses. This was first identified as "The MacMillan Gap" in 1931.

Eighty one years later, the problem has yet to be solved. Despite an accommodative monetary policy, lending remains weak here, while it is starting to recover in the US.

If banks are to expand their balance sheets they need to not only fund this, but also increase their capital to support additional loans. Given a still tough financial market environment, banks most likely will have to raise the increasing capital they need through retained profits.

In addition, UK banks now hold about 15pc of their balance sheets in high-quality liquid assets, mainly gilts. This is a high ratio relative to their peers in Europe, where the European Central Bank has provided liquidity for a very wide range of assets, and thus credit continues to flow into the economy. The US has gone further and actually bought assets from the banks, freeing them up to make new loans.

This fits with the challenging task of getting the economy back on track and doing so in a way in which bigger problems for the future are not created. There is now increasing debate about this across the globe and it clearly has implications for the Bank of England.

Effectively, the central banks in the major economies have become the shock absorber. If there is poor economic news they are expected to do more. The balance sheets of the major central banks is now more than $18 trillion (£11 trillion), or 30pc of global GDP, and rising.

This is a concern. The Bank of England's balance sheet has ballooned since the crisis, having risen from only £86bn at the end of 2006, to £396bn now.

Although the post-crisis stimulus helped limit downside risks, perhaps even preventing depression, the worry is that policy here, and by other Western central banks, may have significant unintended consequences. Markets no longer price properly for risk. The pressure on governments to take tough, longer-term decisions is being eased by the actions of central banks.

This brings to the fore the issue of future exit strategies. When the crisis broke, a few things became clear: the large size of the UK shadow banking industry; the scale of business between financial sector firms with little economic benefit; and, as central banks became more involved in bailing out economies, the need for them to have a credible, co-ordinated exit strategy.

Just as the economy got used to liquidity in the boom, it is now becoming addicted to low interest rates. Getting the speed and scale of tightening right will be key, as premature tightening would be painful. Indeed, I think interest rates will stay low for some time.

This UK economy may finally have hit bottom and started to turn the corner. Ahead, one of the great challenges is to position the UK in a rapidly changing world economy, where there is a shift in the balance of power towards the East.

One of the UK's vital industries is its financial sector, and not just in London, but across the whole country. The need to defend and promote this, while ensuring it does not implode again, is vital.

Given the importance of Britain as a trading nation and of London as a global financial centre, the Bank of England's role in leading the City will be key.

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