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INDEPENDENCE OF THE BANK OF ENGLAND

Introduction

This issue has been studied a number of times before, most recently in the paper attached to [REDACTED] minute of 28 March 1991. Since then

- the UK has a further year's experience of the ERM
- there has been significant convergence of inflation rates, short term interest rates and long term interest rates.

Difference vis a vis Germany

	Q1 1991	2 June 1992
Inflation	+5.2	-0.2
Short term interest rates	+3.4	+0.2
Long term interest rates	+1.8	+1.2

- The Maastricht treaty has been signed (though not ratified) incorporating convergence criteria requirement to make the Bank of England independent by the start of Stage 3.

This paper reassesses the arguments in the light of these developments. In particular, it examines the implications of establishing an independent central bank in the ERM, but in conditions falling short of EMU.

2. One can distinguish three different situations, in all of which the central bank has responsibility for monetary policy free from direction by the Government.

- (i) a freely floating currency
- [REDACTED]

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(ii) a fixed rate arrangement for a group of currencies but where the currency concerned is the numeraire

(iii) a fixed rate system where the currency concerned does not have the power to influence the position of the system against third currencies.

Most previous discussions of central bank independence have been in the context of (i)-(ii), whereas the UK now finds itself in (iii).

3. The first case is represented by the US. Formally the US Treasury has responsibility for the exchange rate, but in practice there are no fixed parities. The position of the dollar is therefore largely determined by the monetary policy set by the Federal Reserve Board. In any case, the US is a large economy where foreign trade is relatively less important. Domestic monetary policy is therefore prominent in determining inflation. In these circumstances, there is substance to the duty to maintain the domestic value of the currency.

4. The second case is represented by Germany. The Bundesbank's statutory objective of "safeguarding the currency" is taken to refer to external as well as internal stability, though it is the Government which has the power to decide the terms of Germany's membership of the ERM. But the weight of the DM in the ERM is such that it is the Bundesbank's monetary policy which is the dominant force in determining the position of ERM currencies against third currencies. Again there is substance to the Bundesbank's statutory duty.

5. The position in the UK is different. Within the ERM the Government is responsible for determining the exchange rate objective. Monetary policy is directed towards sustaining the declared parities. It makes no sense to lay upon the Bank a duty to maintain the domestic value of the currency since one of the main determinants of that, the parity against ERM currencies, is set by the Government. It would be possible to give the Bank a

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duty to sustain the external value of the currency and to give it sole responsibility for the conduct of monetary policy to that end. While the Bank would be independent in the way it operated monetary policy, it would still "take instructions" from the Government on the object of its operations. It is questionable whether it would therefore be independent in the sense of the Treaty.

6. It is a matter of argument, therefore, whether a central bank, other than that of the effective numeraire, can be fully independent within the ERM. Nevertheless, to give the Bank responsibility for maintaining specified priorities would involve major changes to the conduct of economic policy in this country. It would be for the Bank

- to assess monetary conditions
- to decide tactics in operating in money markets
- to make changes in the level of interest rates
- to decide the pace at which rates should be moved up or down
- to intervene using foreign exchange reserves
- to undertake borrowing to replenish the reserves if required.

Even if the Bank were charged with the specific, rather technical, objective of maintaining sterling within narrow bands, it would be desirable to make a number of institutional changes.

7. Status and role of Governor. The Government should appoint someone capable of taking on the enhanced responsibilities, and of explaining and defending them to the public and overseas. The person chosen should also have sufficient authority so that if he believed the Government's policies were inconsistent with the remit given to the Bank, his views would be taken notice of.

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8. Nature of the Court. At present its composition is largely geared to helping the Governor carry out his function as "voice of the City". It is not the forum in which monetary policy is determined and few of its present members are equipped to contribute to such a debate. One approach would be to continue as now, leaving monetary policy as the responsibility of the executive directors. It might be preferable, however, to broaden the base of responsibility and turn the Court into a Monetary Policy Committee, with its membership chosen with this in mind. As the UK does not have a federal structure from which to draw a representative group, this would be more difficult than in Germany or the US. The requirement would be for people with wide experience and judgement, but who did not bring with them attachments to other organisations which would bias their views. Where such people would come from in the British social and business structure is not clear.

9. Openness. Both the US and Germany have structured arrangements under which monetary policy decisions are taken eg scheduled meetings, votes, publication of outcome. We would need to consider how far down this road we want to go.

10. Coordination. This could operate at a number of levels. The first stage might be cross membership of officials - the Treasury joining the Bank's monetary review committee, Bank officials, the Treasury forecasting group.

11. Going up in level of formality, a senior Treasury official could be an observer at the Monetary Policy Committee. (In theory this could be a Minister, but in practice this might confuse rather than clarify levels of accountability.)

12. Finally there would need to be a mechanism conflict of policy objectives. The Bank, for example, might feel that the objective rate was no longer tenable, or that other Government

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policies eg pay, government spending or borrowing, needed to be modified. The Bank might formally ask to be relieved of the remit unless it was changed. The Treasury might have doubts about the way the Bank was conducting monetary policy or intervention. In these circumstances there would need to be formal exchanges between Governor and Chancellor, going beyond whatever informal contacts they maintained.

13. Stewardship of the Reserves If the Bank had a remit to maintain specified parities, one of its instruments would be intervention. One possibility would be to transfer ownership of the reserves to the Bank. This could be the whole EEA or only part of the reserves on the grounds that only part is for use in intervention, the rest being a reserve for use in time of emergency. These are issues which arise in the context of EMU and which need to be resolved in any case.

14. Accountability At present the Chancellor is accountable to Parliament for the entirety of economic policy. Though the Governor gives evidence to the TCSC, this is more in the nature of background briefing to the Chancellor's own appearance. (In context of banking supervision the Governor does appear on his own responsibility.)

15. If the Bank were given responsibility to conduct monetary policy or to maintain specified parities, it is not clear how accountability would develop. There could be arrangements for the Governor to table regular reports or to give evidence at Select Committee hearings. The difficulty arises in the case of debates. It seems inevitable that Ministers would be called upon to defend the Bank and muster Parliamentary support if there were a vote. This would be most acute in the case of a no confidence motion in the Governor.

16. In practice the nature of the debate is likely to change. At present this is conducted on the premise that Ministers are responsible for the level of interest rates and the impact they have on the economy. If responsibility for the conduct of

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monetary policy were allocated to the Bank but within clear guidelines set by Ministers, it would soon become apparent that concern about the effects of monetary policy on the economy would need to be directed at Ministers. There would be little point in directing fire at the Bank since their response would be they were conducting policy within the framework given to them. The argument would be likely to switch the Government's exchange rate objective, and its fiscal policy. Once it had, accountability might operate very much as now.

17. Funding. At present the Bank is responsible for operations in the gilt market and has a very large say in the choice of borrowing instruments. In practice it is the Bank who makes the initial proposals about the next funding moves, based on its assessment of market conditions (the shift in emphasis towards auctions, with a clear pattern of deals and size of issue is tending to cut down the Bank's discretion).

18. With a quasi independent bank operating within an ERM framework, it would be possible to continue this arrangement. Alternatively, a change in the Bank's status could be the occasion for a wholesale change, with the Treasury setting up a Debt Office entirely separate from the Bank. Intermediate solutions can also be envisaged eg Treasury initiatives with the Bank as agent. The choice does not appear, however, to be dictated by a change in responsibility for monetary policy.

19. Supervision Similar considerations apply. Responsibility could be hived off altogether, as the supervision function could remain with the Bank but with greater separation from its other functions. These issues are being considered in a separate paper by [REDACTED]

20. Financial control With the limited independence being discussed in this paper, it would be possible to maintain the existing arrangements from which the Treasury is the stockholder and affects the manner in which the Bank's operations are

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financed. At present the Treasury agrees policy on the dividend, which gives it a locus in a variety of the Bank's operations where these could affect the surplus. These understandings might have to be modified if the Bank was given freedom to conduct monetary policy operations. The Treasury would have, for example, to accept losses which arose from monetary operations, in the same way it accepts losses arising from exchange rate operations.

21. A framework There are various options on the extent to which a change in status was formalised. The minimalist approach would be to leave the statutory framework unchanged but to announce that under S[] of the Bank of England Act 1948, the Treasury was giving a permanent direction to the Bank that it was to conduct monetary policy so as to maintain a specified parity with the ERM.

22. A White Paper could be produced setting out the new policy, the arrangements agreed with the Bank for consultation with Ministers, for reporting to Parliament, and for the internal arrangements for decision making on monetary policy. Parliament could be asked to approve the proposals.

23. Alternatively, the new arrangements could be given a Statutory framework. This would be required in any case if there were changes to the Bank's constitution eg to the Court. The process by which Ministers set the Bank its objectives would need to be laid out rather than the precise objectives themselves which might change over time.

Conclusion

24. This paper has sought to examine the implications of giving the Bank a qualified independence, for example by giving it a remit to operate within an ERM exchange rate framework set by Ministers. The following conclusions emerge

- (i) It would be misleading to describe this as full independence where the Bank has a duty to safeguard the
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value of the currency, or achieve price stability. The parity against other currencies would be set for it by Government.

- (ii) Such a change would nevertheless have far reaching effects on the way economic policy is discussed. Interest rates would be seen much more as means to an end, the focus would therefore be on the ends dictated by government.
- (iii) To operate such a system would require considerable changes in the way the Bank conducts its affairs. Arrangements would need to be established for the Bank to report to Parliament on the conduct of the operations. Whether Parliament would accept a system in which Ministers disowned responsibility for day to day operation of monetary policy is open to question.
- (iv) Arrangements would need to be devised to resolve conflict between the objectives set for the Bank and the other policies being pursued by Ministers. These could range from consultation and exchanges of information, to formal requests by the Bank to be released from its remit.

30 June, 1992.