Lessons for the Bank of England from the ERM, the banking crash and Brexit

I am reproducing this article which was recently posted on CapX in co-operation with the Centre for Policy Studies:

There is no such thing as an Independent Central Bank. They are all the creatures of the states that own them. To those who thought otherwise the virus is changing the reality and rhetoric. Central Banks and treasuries are working together to try to offset the damage lock down and closures are doing to economies.

In some parts of the world this is nothing new or unusual. The People's Bank of China proudly proclaims that it follows policies to promote the wider economic goals of President Xi. They set out how they work in harmony with the government, and how monetary and fiscal policy combine to deliver the aims of the state. In the USA the Fed has twin objectives for inflation and growth, and understands it needs to work with the Executive government and set its monetary policy into the general economic policy framework.

Any dictator ensures the central bank bends to his will and may appoint a friend or family member to ensure it does. In some of the democracies there has been a myth in recent decades that their central banks are independent. This is allied to the view that a small team of dedicated officials are better equipped to make crucial decisions about interest rates, money and credit than elected politicians. This can elide into a view that they are going to get these judgements right. As a result the officials are in various ways placed outside the normal political exchanges that characterise a lively democracy. Whilst Oppositions can debate the conduct of economic policy, the position on tax and spend and all the things the government does, there are attempts to put banking, credit and interest rates off limit from full democratic scrutiny on the grounds these are "technical". This view has been particularly prevelant in the EU, where the idea of so-called central bank independence was incorporated into the Treaties and was a requirement of the Euro scheme. It has worked out rather differently in practice.

It is true that a democratic government can create a so-called independent Bank for a period. The independence lasts for as long as the central bank pleases the government, for as long as no other overriding policy issue arises which takes priority, and for as long as the opposition parties go along with it. Maybe the closest we have seen to an independent central bank was the German Bundesbank in the post war period. It did a good job at allowing decent growth whilst keeping inflation low. It attracted cross party support, so it appeared that it was indeed independent. Two issues then came to the fore in the 1990s which revealed the underlying reality.

Even the Bundesbank was not independent when it mattered

The first was the merger of East and West Germany. The government wanted an early amalgamation of the West German DM with the Ostmark. The Central Bank warned of the dangers given the large divergencies in living standards, productivity levels and general performance, but they were overruled. They then argued for a lower valuation of the Ostmark to the DM for the takeover, but also lost that. As a result German economic policy was badly disrupted for a period, with mass migration of labour to the West, and a big build up of state debts to subsidise East Germany. East Germany could not compete successfully at the chosen exchange rate, so suffered high unemployment and needed cash transfers from the West. The Bank had offered good economic advice, but the political imperative was different.

Subsequently the German government decided it wanted to join the Euro. This meant the abolition of the domestic currency which had been developed and burnished so successfully by the Central Bank. Again there was no point in the Central Bank objecting. The German Central Bank was effectively abolished as a so-called independent body with its main powers transferred to the ECB without a fight.

How independent was the Bank of England?

In the UK so-called independence was claimed by the Labour government first elected in 1997 . The government changed the Bank's Statutes and argued they had made the Bank independent. The reality was very different. Gordon Brown as Chancellor thought there was a Labour problem with the City. He feared there was always the danger that a Labour government would once again lose the confidence of markets. The 1945 and 1966 Labour governments had both been through the trauma of devaluations with required austerity policies to follow. The markets had forced a change of economic policy on the 1974-9 Labour government, including a trip to the IMF to borrow more with onerous policy conditions. Gordon Brown thought that the spin of a more independent Bank would reassure and make such economic disasters less likely. He invented a very lopsided and limited view of what an independent Bank might be like. The Bank of England was shorn of powers to manage and raise the state debt in the markets. It lost its powers to regulate commercial banks, crucial to the pursuit of a successful monetary policy. Arguably the loss of these considerable powers and the knowledge of markets they bestow was an important contributory factor in the poor decision taking during the banking crisis in 2007-9.

The Bank was given more control over setting interest rates, so it became a large organisation revolving around a Committee which mixed full time insiders and outside part time contributors which met monthly. Even this power was less than complete. There were probably plenty of contacts between the Treasury and the Bank behind the scenes so the Bank would be aware of the views of the government on monetary matters. On one occasion when the Chancellor probably feared a rise in rates he did not want, he decided to change the remit of the Monetary Policy Committee. He shifted the inflation target from the more buoyant RPI to the more restrained CPI so there was less excuse to hike rates.

When the banking crisis was at its height with money too tight and commercial banks in great distress, the leading Finance Ministers of the world including the UK Chancellor of the Exchequer agreed a concerted move to stabilise markets by all cutting interest rates together. In order to preserve the fiction of independence the UK Monetary Policy Committee hastily put together a meeting out of its usual cycle to agree spontaneously and" independently" to cut the rates in the way Finance Ministers wanted. The Finance Ministers were on that occasion right, and they effectively overruled so-called independent Banks as they had to do.

Today we see welcome collaboration and joint working between governments and central banks

No-one can have watched the amazing work of the Fed, and of some of the other leading advanced country Central banks in the last few weeks without recognising that they are now rightly working closely with their governments on joint monetary and fiscal packages . They are trying to offset the huge hit to incomes and output from the shut downs designed to counter the virus. It is time to call time on the notion of an independent central bank. It is time to welcome a new era of open collaboration between central banks and finance ministries, serving the same state.

The very architecture of central banks tells you they cannot be truly independent. Heads of central Banks are government appointments, usually chosen by the President/Prime Minister or by the Finance Minister. Some elected Assemblies have rights to confirm or reject the appointment, and to cross examine incumbents on their policies. No Parliament or Senate has the right to select and appoint against the wishes of the government. If there is an interest rate setting Committee, that too usually has appointees chosen by government. Central banks operate under a legislative framework set by the governing majority in the legislature.

What the legislature can support, it can also amend. In the UK the so-called independent central bank suffered surgery by legislation when a more independent rate setting Committee was established. There was further legislative change at the next change of government, with some powers being restored and the framework being amended. In some democracies central bank Governors are changed when there is tension with the government. Both India and Turkey have seen changes of Governor to get their Banks more into line with the strong minded governments running those countries.

The doctrine of central bank infallibility

The idea of independence is based on the common fallacy that rule by technocrats is preferable to rule by elected politicians because they know the answers to how their areas should be run. Why not leave running banks, money and credit to bankers? And leave running health policy to medics, the criminal justice system to lawyers and the education system to teachers? After all, they are qualified, know what they are doing, and will not "play politics" with the great services they are involved with. The rule of the technocrat is particularly favoured in the EU, where the demands for evidence based policy produced by specialists is often most developed.

There are several main problems with this viewpoint. The first is the assumption that all bankers will decide on the same answer for any given banking problem, or all lawyers will have just one view of what the law is , or that all medics will agree on what is the correct treatment for difficult diseases. The professions have as many arguments about what is the right course of action as politicians have. There has to be some way of concluding these rows to turn opinions into policy.

The second is the assumption that experts will always be better at making right decisions than generalists charged with making decisions in the public interest. The elected Ministers have the advantage that they can call on any expertise they wish without themselves usually having any commitment to one professional faction or view over another. They can also make decisions which balance the best technical answers with the wider impact these may have on society, and can see the interplay between narrow professional fields and the wider public interest. There may be a conflict of professional advice. In the current crisis the best remedies proposed by economists for prosperity may be very different from the answers favoured by health experts to deal with the virus.

The third is that so called experts have a right to be exempt from tough cross examination by journalists and politicians seeking the truth or trying to force a change of policy. It means technocratic government escapes the challenge and the need to think things through and defend them that Ministers are used to. It makes mistakes more likely.

The fourth is the assumption that because people are experts everyone else will accept what they say. The danger is if a group of experts of one way of thinking hijack policy in a particular area, they build resentment not just against their policy but against the whole system, as those suffering from it cannot see an easy way of changing it.

The major decisions have to be taken by elected officials who can weigh the conflicting claims, decide what the state can afford and draw on the best professional advice in the relevant fields.

The Bank of England’s experts have been more often wrong than right for the last 50 years

It is time to review the record of the Bank in its roles as setter of interest rates and regulator of the banking system over the last half century. The period began with the secondary banking and property crash which compounded the damage of the international oil price explosion in the period 1972-5. It led on to the 1989-92 Exchange Rate Mechanism disaster. It was followed by the big boom and bust culminating in the great banking crash of 2007-9. More recently we witnessed the Bank get its forecasts hopelessly wrong over the likely impact of Brexit, only to pursue an inconsistent and damaging monetary policy from 2016 to 2019. In each case the Bank made wrong forecasts and took bad decisions about the permissible levels of credit in the banking system. These were followed by over reaction to create a recession which then did damage to the economy.

The Exchange Rate Mechanism was the most perfect example of rule by the technocrats which went badly stray. The member states of the EU in the 1980s had widely divergent economies. The differing levels of inflation, debt and productivity caused considerable fluctuations in exchange rates. The countries with too much debt and inflation tended to devalue and the countries with strong balance of payments positions and low inflation tended to have strong currencies, led by Germany.

The advocates of European monetary union combined with the technocratic tendency to require the states to lock their currencies one to another within tightly proscribed fluctuation bands, with a view to reducing and finally eliminating currency variations. This they thought would move all the countries onto something like the German pattern with low inflation and reasonable growth. The UK was told by advocates of the ERM we would enjoy a "golden scenario of low inflation and good growth". If only.

I argued that the ERM would instead prove destabilising, leading either to an inflationary increase where markets thought a currency was too cheap and should go up more than the bands allowed, or to a recession where markets thought a currency too dear and it should fall below the floor price allowed.

In my 1989 pamphlet for the CPS on this I said:

"The idea of the EMS (ERM) is theoretically flawed. The history of the pound against the DM over the last year illustrates why this is so. Despite government efforts to get the pound to shadow the DM and to hold it around 3DM, there have been periods of intense pressure leading to substantial fluctuations around that level. The main method for trying to keep the currencies in line is the sale or purchase of large quantities of the given currency by European Central Banks, acting in concert or individually. …………This action is intrinsically destabilising. If the Bank of England sells a large amount of sterling…. It then has a monetary problem. If it simply creates the pounds it has sold it adds directly to the money supply. Foreign banks and other buyers have more pounds at their disposal . If they go into the banking system they become high powered money, enabling a commercial bank to lend this money several times over expanding the amount of sterling credit in circulation. This produces upwards pressure on the British price level, causing inflationary worries and forcing a further rise in interest rates.….leading to a further demand for pounds requiring more pounds to be made and sold by the Bank of England."

Once the inflation is well set the reverse sets in. Foreigners sell the pound, the UK has to buy up pounds. This contracts the money supply and brings on recession, aided by the need for even higher interest rates to defend the pound.

This was all obvious to a few when I published in April 1989. I lost the argument in government and we entered the ERM. It duly unfolded in a predictable way. The pound wanted to go up. Money growth and inflation accelerated. The pound then wanted to go down,. Rates rose too high, credit contracted and we entered a recession. The technocrats had proved to be sadly so wrong. This scheme was heavily backed by the Treasury and Bank of England,

and supported by the leading opposition parties. When it failed many of its supporters claimed it had been badly executed or had been done at the wrong exchange rate. That was strange, as when we entered they did not complain about the rate which had been carefully calculated by the Bank and Treasury on the basis of past currency movements. The experts had their way and got it wrong. The price of their mistake was many bankruptcies and lost jobs.

In 2005-9 the UK went through an even more extreme boom/bust cycle than that in 1989-92. The so-called independent central banks and Bank Regulators presided over a big build up in lending to both public and private sectors, and to a huge expansion of derivatives, future and options which added to the levels of financial gearing in the system. Many people and institutions raised doubts or objected, but treasuries and central banks assured us all was well. In the UK both the Conservative and Liberal democrat Opposition parties argued there was too much debt. The official reply from the central bankers and treasury ministers was the financial world was now a lot more sophisticated. The extra credit was an acceptable risk, with better controls thanks to all the special financial instruments. They allowed commercial banks to greatly expand lending without proportionately expanding their capital. In due course general inflation started to rise, to reinforce the inflation of asset prices which was well embedded.

Central banks then decided they needed to control the inflation by throttling back the credit. They started to hoist interest rates, This sent shudders through the debt and derivative laden markets. The central banks lectured the financial world that they needed to rein in their excesses. Doing so in public and demanding immediate change speeded the collapse. Soon some of the largest institutions were illiquid with questions over their longer term solvency. The central banks left the squeeze in place long enough to threaten the whole system, before relenting and pumping cash into the banking markets to avoid a complete collapse. Once again the technocrat bankers ands regulators had been given their head, and once again their judgements had proved faulty.

The Bank of England also showed a poor understanding and a lack of political sensitivity over the Brexit period. It took an active role in supporting Remain in a strongly and evenly fought referendum. In general elections the central bank wisely keeps out of economic disputes and does not mark the homework of the leading parties. On this occasion it decided to intervene on the losing side by producing a series of ill-judged forecasts alongside the Treasury to try to help Remain. Its famous short term forecasts of what would happen if we simply voted to leave were proved wrong in most respects in the two years that followed a Leave vote. The economy did not sink into recession. House prices did not crash. Unemployment did not soar. The Bank followed this unfortunate political and economic judgement by following an erratic monetary policy after June 2016, before settling on a generally negative policy of tightening monetary conditions to slow the economy.

Governor Carney arrived at the Bank of England from Canada with a new approach. He told us all he was going to give forward guidance on interest rates to avoid shocks to the markets. On three occasions he prepared us for a rate rise, only finally to cut rates when he did want to make a change. This was not helpful, and reminded us of the limits of the technocratic approach to Central banking. Immediately after the Referendum vote markets fell then rallied strongly. A few weeks later the Bank of England cut interest rates and loosened money policy, driving the pound down. In the following spring the Bank then decided to start tightening money which eventually slowed the economy markedly by the end of 2019. There was no obvious rationale for any of this.

The Euro – a currency in search of a country to back it

The Euro is the ultimate technocrat dream. Here is a currency and a central bank with considerable economic power that is not answerable to any single country or government. The president of France or the Chancellor of Germany cannot dismiss or even influence the President of the ECB. No member state can legislate to change the rules and guidance which govern it. The founding Statutes for the Bank represent a triumph for the German view. The European Central Bank will not fund the deficits of individual member states in the way a single country central bank can do in extreme conditions.The ECB can insist on the common EU rules governing state debts and deficits which need to be controlled under the Treaties. If an individual member state borrows too much then it will have to pay more for its next borrowings or will need to raise taxes or cut spending instead. The inflation target will be observed and is an average rate across the whole zone.

When the Germans and the other financially strong Northern states consented to the Euro they assumed the disciplines of the scheme would gradually make the southern states more like the north, as they had hoped for their ill-fated ERM. Instead the unimaginable happened. The world banking crash as replicated by the ECB and Euro regulators left the EU economy weak and with little inflationary pressure. The ECB ended up with zero interest rates and persistent high levels of state debt with little growth.

The German/Dutch surpluses on balance of payments accounts left the south short of Euros.The northern states refused to send them grants out of their tax revenues in the way stronger parts of a single country currency union do to help weaker parts . So the ECB allowed the Target 2 balance system to massively expand. This was meant to be a facility where a surplus state would make a short term deposit at the ECB which could be lent on to a deficit state, to clear overnight or weekly imbalances. Instead this became a semi permanent massive set of loans, with Germany currently depositing €930 billion with the ECB matched by large borrowings by Italy, Spain, Greece and Portugal, all at zero interest.

The technocrats have created another unstable edifice. Italy and others wants the EU to issue EU bonds to direct money paid for by all taxpayers in the Euro area to be spent in the places that need it most. So far the northern states refuse, so the ECB does the best it can to ease Euro shortages in the south. When the newly elected President of the ECB Mrs Lagarde let slip in a news conference that the Bank did not think it needed to ensure Italy could borrow at low rates related to Germany’s, the markets sold off Italian bonds rapidly. Shortly afterwards her remarks were clarified, and it turned out the relative cost of Italian debt was a matter of concern. The price of the error combined with the new needs of the time was an additional €750 billion of bond buying by the ECB, with more Italian and Greek bonds as part of the mix.

What makes a successful central bank

A successful central bank reads the cycle well and is sensitive to the economic and fiscal policy being followed by the government that backs it. The last 50 years have seen wild swings in approach, from allowing too much credit to being too tough on credit and inflation. These boom bust cycles have been augmented by the strange architecture of the ERM and Euro.

The current virus crisis is generating better signs of collaboration both in the USA and the UK between central Bank and government. This is welcome. Now they need to read the cycle wisely. All the time we have lock down they need to provide a lot of joint offset or stimulus. When we get to the recovery phase they need to gradually reduce stimulus at an appropriate pace. They need to allow enough cash and credit to extend the recovery phase without allowing so much that we have a worrying rise in inflation. There should be no restraint on people in a democracy discussing these policies and being critical if they wish. They are all judgements which have a big bearing on jobs and prosperity. By all means encourage expert debate, but recognise the experts do not always agree. I am all in favour of evidence based decisions. I admire successful expertise. I also think decisions are usually better founded if there is informed scrutiny of why and how they were made.

We should beware of the siren soundbite. The ERM did not deliver a “golden scenario” as promised. The Euro has not so far delivered the solidarity and stability its advocates often urge. At a time when monetary policy is being expected to deliver even more in difficult circumstances, the ECB needs to talk seriously to its EU Commission government about burden sharing, joint financing and banking stresses within the zone. Meanwhile it is good to see the USA and UK entering a new era of collaboration between central banks and governments, which needs sufficient debate and exposure to help it deliver better results than the era of so-called independence.