BANK OF ENGLAND

Speech

Positive Externalities

Speech given by
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It is a great pleasure to have the opportunity of speaking to an audience in Belfast. I used to come here very frequently in the mid-1980s, not the easiest time in Northern Ireland's recent history, when I was responsible for a division of Courtaulds which had operations in five of the six counties, and I became very attached to the place. I also owe an enormous debt of gratitude to the inspired teaching of an Ulsterman, Edward Barbour, who opened my young eyes to the classical world. I am delighted to pay tribute to his memory in this, his native city.

Since I am coming to the end of my term on the Bank of England's Financial Policy Committee I should like to share with you some observations about the way such a body in my opinion best ought to function, comparing and contrasting it, as the examiners say, with analogues in the private sector, where I have spent the bulk of my career. I should also like to consider how the creation of the FPC has changed the relationship of the Bank to the public sphere.

This is not the place to go into the mechanics of the FPC's meeting schedule; for those who are interested, my colleague Anil Kashyap gave an excellent speech last June, entitled "Come with me to the FPC", which I heartily recommend; it is easily available on the Bank's website.[1] But I should perhaps remind you that I am one of five external members – that is to say, outsiders who are not full-time Bank employees – alongside six members from the Bank, the chief executive of the Financial Conduct Authority and a representative of HM Treasury. The Bank members are the Governor, who generally chairs the meetings, and his four deputies, along with the executive director of financial stability. On the face of it, that there should now be four deputy governors where 25 years ago one was thought to be plenty looks like a classic example of the British productivity problem over which the Bank's economists puzzle so much – puzzle unaccountably, perhaps, if the answer is staring them in the face. In fact, each of the four probably has more to do than their single predecessor had in the past, which speaks to the enormous expansion of scope of the Bank's operations.

The FPC, in existence now for six or eight years, depending on whether you count, as I am very much inclined to, its pre-statutory phase, has external members to mirror the structure of the Monetary Policy Committee, set up in 1997 when the Bank was first given the independent responsibility for meeting the inflation target set by Parliament. That policy independence was enlarged 16 years later by setting up the FPC to take responsibility for financial stability.

The externals came as part of the independence package, so to speak. All sorts of safeguards were understandably thought necessary when powers were given to an unelected body, the most important of which is that the Bank is directly answerable to and seriously scrutinised by Parliament. The idea was not only that the external members would bring outside expertise to the committee deliberations, but also that

[1] Anil Kashyap's speech can be found here: Come with me to the FPC.

they were more likely to be able to act independently of the Governor than people who worked directly for him or her.

Questions arise from time to time about the continuing desirability of central bank independence. Those who oppose it tend to exaggerate its extent – they talk as though the Bank of England had been given unfettered freedom of action in all directions, rather as if the Treasury were a mid-20th century power which had embarked on a process of benign decolonisation. In fact the Bank remains quite clearly an arm of the state, and – as we saw in the immediate aftermath of the 2016 referendum – a highly effective one. Its independence is limited to policy responsibility in precise and restricted areas, and it is, as I have said, subject to parliamentary oversight.

In addition, perhaps not all those who go on about unelected officials remember the debates of the 1990s. They forget that the electoral cycle has unintended consequences for policymaking. Those newly elected may indeed be held, for a while at least, to represent the views of voters; purified in the crucible of campaign and manifesto, they can surely be relied upon to do the right thing. But those seeking re-election, alas, cannot always be trusted to make decisions, especially those involving, for example, the setting of interest rates, in a disinterested manner. This weakness, of which there was ample evidence in pretty much every country, was the condition that central bank policy independence was devised to cure. It was a signal act of renunciation by politicians conscious of the temptations they faced.

Long ago, perhaps in 1981 or thereabouts, when I was a journalist on the Financial Times, I went to cover the annual results of the then Cadbury Schweppes. Over lunch afterwards I found myself talking to the company chairman, Sir Adrian Cadbury. We must have run out of small talk and exhausted our micro-analysis of the markets for confectionery and soft drinks. I suppose, looking back, that I ought to have asked him about Corporate Governance, which he was later to invent, but at the time we were both in the dark about this; after all, the young Pythagoras might have been baffled by a penetrating question about the square on the hypotenuse. Instead I asked Sir Adrian about the Court of the Bank of England, of which I knew him to be a member. What was the function of Court? I asked, not intending to be awkward, simply trying to make conversation. He sat up very straight and replied “To support the Governor”.

Then as now, FT journalists were not drawn from the ranks of the hyper-radical, but I remember, priggish young man that I was, feeling a sense of horror and revulsion. Here it was, then, the pure voice of the Establishment in all its self-serving, self-referential, don’t-rock-the-boat complacency. Today, my equivalent might be consumed with dark thoughts about the global neoliberal elite. Some 40 years on, having had time both to reflect and to grow up a little, I now believe Adrian Cadbury to have been broadly right.

The Governor at that time was Gordon Richardson, who certainly needed a bit of support, pounded as he was day and night by Mrs Thatcher’s heavy artillery, accused of being wet, as a generality, and, in particular, of failing to control the money supply (he was guilty on both counts, more or less). He himself memorably

characterised their relationship: "We don't get on; I am a cat, she is a dog". Allow me to note in passing the limpid simplicity of this remark, simplicity being a quality not always associated with central bank communications. Twelve consecutive monosyllables; no need for an infographic to explain what he meant, though it would be easy enough to devise one.

I don't suppose the support Sir Adrian envisaged went much beyond a pat on the shoulder and a murmured "Chin up, old chap". And the Court of the Bank – its board of directors, to use a rough and ready analogy – in 1981 is not the same as today's Court, let alone a policy committee like the FPC. But supporting the Governor? Aren't we supposed to keep him under control?

Well, up to a point. The job of a policy committee is to make policy. In this way it differs from boards in the private sector, which have to struggle with more complex mandates.

I have found that private sector governance enjoys a mysterious, if largely undeserved, prestige in the public sector. Top civil servants may regard their private sector counterparts with a curious blend of sneaking admiration and half-concealed disdain, but many of them believe there is a lot to learn from how companies organise themselves. A very senior general once asked me what I thought the Army could learn from boards. I know very little about the Army, but I was able to tell him that the structure of company management, first perfected, if that's the word, by General Motors in the 1930s, was largely derived, with all its reporting lines, spans of control and command structures, from military models. By studying how corporate practice had evolved, the Army risked, it seemed to me, looking at its own image in a distorting mirror.

Non-executive directors teem in the public sector, and private sector norms have proved infectious. So when the Treasury Select Committee was concerned, in the years immediately following the financial crisis, about the extent of the powers wielded by the Bank of England governor, it was heavily influenced, perhaps subconsciously, by the UK private sector rule first established by Adrian Cadbury that the roles of Chairman and Chief Executive should be split.

The analogy is telling, but imprecise. At the heart of the private sector board is a contradiction which amounts to a glaring structural weakness. The directors are supposed both to contribute to the formation of the company's strategy and to judge those who execute it. As a result, their relation to executive management is at once collaborative and adversarial. Most of what goes wrong on boards arises from a failure to balance these opposing requirements – often an understandable failure, since they do not sit easily side by side. Boards have the power of appointing and removing the business leadership, a power which they seem to exercise very frequently, as if afraid it might be taken from them, rather as ramblers zealously hack their way through brambles to preserve Rights of Way. My own view formed over many decades is that the corporate board should principally play a defensive role; it exists above all to prevent catastrophic outcomes. Good governance, and there is plenty of it, passes largely unnoticed, while a board in the wake of

a company failure looks like a collection of idiots. In the financial sector, with which the FPC is principally concerned, it is inescapably clear that most boards in the early part of this century did an absolutely shocking job.

Policy committees, in contrast, do not have the power of appointment and dismissal. Members are not responsible for the composition of the body on which they sit. It follows that their duties are overwhelmingly collaborative rather than adversarial. This should make it much, much easier for them to function without Shakespearean alarums and excursions.

Let me also add a practical observation concerning another difference between private sector boards and the functioning of the FPC as a policy committee. You will know that British company law considers all directors to be equal. Our boards are unitary, unlike in, say, Germany, where a two-tier board system operates, a management board chaired by a CEO and a supervisory board without executive membership (though executives will often participate in supervisory board meetings). But the British system, in the private sector, is increasingly enshrining a sort of legal fiction: companies are in practice run by executive committees, which may have no legal standing whatsoever, while directors on the main board, supposedly equal not only in status but also in nature, are in practice anything but. I find it curious that in the ostensibly unitary private sector body, non-executives are genuinely different from executives; in the Bank of England committee, meanwhile, the statutorily distinguished roles of external and internal members – considered purely in the committee context – are in fact converging, a point I will come back to in a moment. As sometimes happens in Britain, we reach what may be a reasonable solution while pretending to be doing something quite different. Whether this arises from hypocrisy or tolerance of ambiguity is hard to say.

Having established that the job of a policy committee is to make policy collaboratively, what can an external member most usefully bring to the table?

Independence of mind has always seemed to be the most crucial thing, and it's less abundant than one would like, even if, as Descartes said about common sense, there must be a lot of it about because everybody believes they possess it. Independence of mind implies, of course, being prepared to stand one's ground and stick up for an unpopular view; it does not mean seeking out unpopular views so that there is always a new ditch to die in. The three things that non-executives most often get wrong are, firstly, not understanding the material being discussed (shockingly prevalent in the world outside, though very rare at the Bank). Often of course dazzlingly important people are too grand to confess that they don't understand something. The second deformity is to be too eager to agree with everything proposed; the third to be too eager to disagree. The board or committee member who has his own version of the truth and considers the unwillingness of others to align with him as evidence of their cowardice or venality is a menace, except on the very, very few occasions when he turns out to be right.

It is vanishingly rare for a non-executive director to make a contribution to strategy that no one in the company had thought of. The insiders simply know so much more about the industry in which they operate than non-executives can expect to do, partly because increasingly strident rules to prevent conflict make it difficult to appoint people with experience of the industry concerned before they are entirely superannuated. In the private sector, the non-executive is much more likely to add value by challenging management's over-optimistic assessment here, asking inconvenient questions about competitor activity there, raising possibilities of unforeseen regulatory response to a corporate action, pushing to ensure that the balance sheet is solid.

Equally, an external member of the FPC is unlikely to dream up a new and brilliant policy intervention that no one has imagined before. She is more likely to induce the meeting to change an emphasis, to take a developing issue more (or less) seriously, to consider the likely reaction of industry participants to this or that regulatory initiative, or sometimes to point out to the internal group that it is worryingly united in its attachment to the house view. In doing so she may be reducing the possibility of policy error: a useful role indeed.

As for being on top of the material – just as company boards deal with increasingly complex and technical matters, so do the Bank's policy committees. The external members cannot be useful sparring partners for the governor and his colleagues if they are not properly briefed, since asymmetry of information would then undermine any chance of insiders and outsiders meeting on more or less equal terms. The practice has grown up in the Bank during the last two or three years of offering extensive teach-ins by staff to external members; in my view this has immeasurably improved policy discussion and so, one must hope, policy outcomes. It has not fomented group think among the external members – in any case, we are all too angular and disputatious for this to be a serious possibility. Though not an issue in practice, let me dwell on the interaction of staff and committee members for a moment.

The Bank of England runs a school for central bankers from all over the world, and I sometimes find myself running seminars with groups of foreign officials, usually about the FPC's work in macroprudential policy. On one of these occasions a woman from the Riksbank in Stockholm, with all the terrifying bluntness of a Scandi noir heroine, remarked "What do you all do anyway? Surely the staff decide policy?"

I did think of some good answers to this, but not, unfortunately, until after the session had finished. The point that threw me was her unfamiliar angle of attack: it wasn't the over-mighty governor and his colleagues, in her view of the world, who decided things – it was the staff. She was making a serious point – central banks are full of talented and ambitious people dreaming up responses to real and imagined situations, responses which the leadership has to absorb and consider; this all takes place alongside the more familiar circumstance of the leaders asking for work to be done by the staff to support or disprove a hypothesis. Just the same occurs in large companies. A difficulty for the leadership is that some of the staff tend to operate at

some distance from market or political realities that are constantly fluctuating. Wrestling to reconcile theory and practice is the everyday job of leaders of all complex institutions, and they need all the help they can get. In fact I believe the more thorough teach-ins allow us to do precisely this. They have helped to break down the knowledge gap which marked the biggest difference between internal and external members. It is partly because of this that I have found, as I said earlier, that the roles of executive and external members of the FPC are converging. A member of Court observing one of our meetings remarked to me that if she did not know the individuals involved, and based entirely on their contributions to a meeting, she would not be able to tell externals from internals. She clearly meant this as a compliment: this was a meeting of colleagues, not a gathering of yes-men.

The better education, for that is what it amounts to, of external members has increased the number of meetings in which people subtly change their views under the influence of their peers, so that the group comes to a better conclusion than any individual participant could have done. Contrast this with the head-counting and indeed head-banging encounters where two opposed groups shape up to each other; we've all sat in meetings like these over the years; they may be a political necessity sometimes; they may make good movies, but they don't generally produce good policy. And the job of a policy committee is to make policy.

And we have been very busy doing exactly this, particularly with respect to preparing for Brexit.

The FPC has had two roles to perform on this contested subject.

The first has been to draw attention to the numerous matters which, if unaddressed either by the UK or the European Union, might lead to consequences unintended and undesirable: loss of access by customers on one side of the Channel to services from the other side, in all cases with potential for inconvenience. Some potential consequences are not merely inconvenient but downright dangerous for financial stability, which is what the FPC most cares about. We have sought to draw the attention of lawmakers in both the UK and the EU to things that need to be done to head off these dangers, in many cases to good effect.

We began this process in the summer of 2017, about a year after the referendum, when 21 months were left to the withdrawal date, and we have been gradually turning up the volume ever since. The timing of our first intervention was determined by the availability of information more than anything: since preparation for a Leave vote had been very sketchy, and since the areas concerned were both very numerous and very complex, it took something like a year for the Civil Service, working night and day, to get to somewhere near the bottom of the consequences of Britain's decision to leave the EU. I would modestly suggest, as a piece of administrative hygiene, that any future British government deciding to hold a referendum should give serious consideration before the vote takes place to preparing for either outcome.

The second role of the FPC has been to ensure that the British banking system is capitalised to a level that would allow it to withstand a Brexit that one way or the other turned out to be disorderly. We did this at first by designing, at the end of 2016, a stress test for the major banks to be run in 2017 which incorporated some of the economic effects we were afraid a disorderly Brexit might entail, without actually specifying Brexit as the motivation. It was clear that a Brexit stress test could not wait until 2018, since that would leave no time for the banks to raise capital if the test results suggested they would be likely to restrict credit in such a scenario, let alone face the risk of failure.

We felt confident enough to say at the end of 2017 that we felt that our scenario, which the test results suggested the banks were strong enough to withstand, encompassed the risk of a disorderly Brexit. The stress test was indeed very severe, since it envisaged a major international slowdown alongside an untidy Brexit-like effect domestically. In 2018, as it became easier to put flesh on the bones of a disorderly Brexit scenario, we modelled more drastic domestic possibilities.

At no time did the committee consider these outcomes likely, though for many of us their probability has crept up to a level that means they can no longer be considered tail risks of the sort that generally concern the FPC. Our contention has been, and remains, that a seizing up of the banking system and a potential repeat of 2008 were risks that simply must not be run. The committee has shown, in my view, admirable institutional independence. The disorderly scenario actually supposes investors call into question the credibility of the UK's macroeconomic framework and institutions – of which the Bank of England of course is one – a conclusion other parts of the Bank of England can hardly be expected to embrace. It is rather as if French commandos in 1939 had disseminated a paper suggesting that the Maginot Line might prove ineffective (that might, come to think of it, have been rather a good idea). I think the Bank can be proud of its willingness to consider such inconvenient eventualities.

All of this has been done quietly and discreetly, with repeated heavy redaction of meeting records, in order to avoid the appearance of political interference by the Bank. The most recent modelled scenarios were eventually published because the Treasury Select Committee demanded to see them; they subsequently found their way – along with all the now unredacted text - into the public domain via the December 2018 Financial Stability Report. Their message, curiously enough, is intended to be reassuring rather than apocalyptic. If these things happen, the Bank is saying, things which we do not expect to happen but believe might happen, the financial system will hold up. People are free to make what they will of the information that the Bank considers it possible that such things might happen. I would note that the committee did not superimpose on its most recent disorderly Brexit model the coordinated global slowdown that featured in the 2017 stress test, and which looks today decidedly more plausible than it did two years ago. The combination of the extreme Brexit scenario and a major global slowdown would obviously not be a pretty sight.

I mentioned earlier the expansion of scope of the Bank's activities. Greater powers demand greater scrutiny – put simply, what the Bank does matters more than ever, and it should expect to be questioned, criticised

and attacked more frequently, more vehemently, even, than in the past. Hard cases make bad law, as the lawyers say, and Brexit is a hard case if ever there was one. The country has struggled, and is struggling, with profound questions of identity – indeed, competing versions of identity: who are, who is "we" – questions that people in Northern Ireland know better than anyone on earth can be not only uncomfortable but deeply destabilising, as we in mainland Britain are slowly and painfully learning. The Bank as an institution and the Governor as an individual have been accused of taking sides in the Brexit debate; however punctilious your attempts to remain above the battle, it is hardly possible (as everyone in Ireland understands) to open your mouth without being identified with one side or another. More worryingly, to me at least, the Bank has been accused of speaking when it should have remained silent.

Central banks need to be – and are – very careful about what they say, and when and how they say it. Those who believe the Bank should pipe down on all Brexit-related matters rely on the established convention that we do not comment on elections. If one party, say, publishes a ludicrously unrealistic financial plan for the country, it is for other parties to point this out. The central bank should not get involved.

Other features, though, of the environment in which we work have changed profoundly. The great financial crisis of 2008, particularly acute in a country like Britain where the financial industry is very large relative to the economy as a whole, utterly and perhaps irreversibly altered the relationship of that industry to the people and the body politic. The creation of the FPC and the Bank of England's relatively new financial stability remit are a consequence of that seismic event, and I believe are fundamentally changing the Bank's relationship to the society in which it operates – the society it is working to protect. The Bank will now sometimes do things and say things that it did not do or say before, not because it has new powers, but because it has new responsibilities. Preparing for a disorderly Brexit is very much a case in point. Arguing that Governor Carney should not have said this or that because his predecessors would not have done so is therefore beside the point. It probably wasn't their job. It is his job. The Bank strives to be neutral. That does not mean it should be neutered.

I hope the two new external members of the FPC, Jayne-Anne Gadhia and Colette Bowe, find the role as absorbing as I have done over the last six years. They will serve during the transition to a new governor, and they will find their own answers to the question of when in the policy-making process to try to keep the various governors they serve under control and when, Cadbury-like, to support them. As a company chairman I most valued board members who, whatever their position on individual matters, cooperated in the process of making the board more effective. Economists talk of externalities – free side-effects of an activity, good or bad, that affect others. The external members don't come entirely for free, but if they contribute to careful, balanced and thorough policy-making the externalities are highly likely to be large and positive. All the more important at a time when, as Yeats put it, "arrogance and hatred are the wares/peddled in the thoroughfares".

Thank you for having me with you today.