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HOWARD DAVIES

Howard Davies, incoming Chairman of the Royal Bank of Scotland, was the first chairman of the United Kingdom's Financial Services Authority (1997-2003). He was Director of the London School of Economics (2003-11) and served as Deputy Governor of the Bank of England. He writes: In 1993, the economists Alberto Alesina and Larry Summers published a seminal paper that argued that central bank independence keeps inflation in check, with no adverse consequences for economic performance. Since then, countries around the world have made their central banks independent. None has reversed course, and any hint that governments might reassert political control over interest rates, as happened recently in India, are met with alarm in financial markets and outrage among economists.

In truth, however, there are many degrees of independence, and not all nominally independent central banks operate in the same way. Some monetary authorities, like the European Central Bank, set their own target. Others, like the Bank of England (BoE), have full instrument independence – control over short-term interest rates – but must meet an inflation target set by the government.

There are differences, too, in how central banks are organized to deliver their objectives. In New Zealand, the bank's governor is the sole decision-maker. At the US Federal Reserve, decisions are made by the Federal Open Market Committee (FOMC), whose members – seven governors and five presidents of the Fed's regional reserve banks – enjoy varying degrees of independence.

The ECB does not publish voting records and seeks consensus at the meetings of its General Council. By contrast, the BoE's Monetary Policy Committee (MPC) has nine members, four of whom are appointed from outside the bank, and all votes are individually recorded; nobody is allowed to hide behind an institutional view. The Fed does not keep a voting record, but "dissents" from its major decisions are noted (these were almost unheard of when Alan Greenspan was Chairman, but have since become more common).

There are differences, too, in the relationship between policymakers and their staff, which also influences a central bank's independence. At the Fed, the staff present their own economic forecasts to the FOMC, without input from the policymakers who set the interest rate. At the BoE, the MPC is responsible for official forecasts, which it publishes in its Inflation Reports. That is helpful in influencing expectations, because a range of different views from the central bank could confuse the private sector; but it carries the risk of institutional groupthink.

Groupthink can be particularly dangerous if the central bank is also the banking supervisor, as the 2008 global financial crisis demonstrated. In 2006, every central bank that published a financial stability report (in other words, most of them) concluded that their country's banking system was in fine shape: well-capitalized and endowed with robust governance and strong risk management.

It seems unlikely that not a single central bank analyst was the least bit worried about the massive growth in credit and leverage at the time. Economists at the Bank for International Settlements – an organization of central banks – were laying out the risks very starkly. And yet not a dissenting voice was heard from the world's small army of central bank economists. Central banks may have been independent vis-à-vis their countries' governments, but internally it was very difficult to stray from the party line.

There is, of course, a balance to be struck between tight institutional discipline and letting a hundred intellectual flowers bloom. A central bank is not a university economics department, where diversity is almost invariably a source of strength. External observers are bound to try to read policy messages between the lines of any publication, which may not always help the bank to achieve its objectives.

That said, there is clearly room for allowing more heterodox thinking. So it is encouraging that the BoE is experimenting with a platform that enables a wider variety of views to be heard: a blog called Bank Underground (a reference to the Tube station beneath the Bank's headquarters) that publishes posts by junior staff challenging – or supporting – prevailing policy.

In a matter of weeks, Bank Underground already has established itself as a fertile source of provocative ideas. One post in the middle of August (when the Bank's top cats were certainly away, allowing free rein to the mice) pointed to some of the weaknesses in banks' internal capital models, which are at the heart of the Basel 3 capital-requirements regime. The author, a BoE employee named Tobias Neumann, argued that incorporating more data into the models could lead them to pick up noise and mistake it for an important signal. As a result, he concluded, highly complex models may regularly yield misleading information.

Another post, published in July, explicitly challenged the BoE's "official" view that as the economy recovers, we can expect non-financial companies to begin to run down their cash balances to fund investment. The authors, Katie Farrant and Magda Rutkowska, suggest that corporate behavior may have changed as a result of the financial crisis, as difficulties in accessing bank financing led them to increase their cash buffers permanently. If true, this has important implications for the financial system, and especially for banks.

In its short life, Bank Underground has already proved its worth. The BoE's governor, Mark Carney, deserves great credit for allowing us to peer through a small crack in the Old Lady of

Threadneedle Street’s façade (assuming, of course, that the blog is not a wholly unlicensed initiative!).

Perhaps we will eventually see the emergence of a rival Fed Subway blog, though I am not optimistic about the prospects for an ECB U-Bahn blog anytime soon. In the meantime, I plan to spend more time underground. The light seems to be better there.