SHOULD THE BANK OF ENGLAND EXIST?

Tim Congdon

Should the Bank of England exist? That may have seemed a daft question in the middle of 2007, a decade after the Bank achieved 'operational independence'. Those ten years had seen a remarkable degree of macroeconomic stability, with inflation on average matching its target level almost exactly.

But central banks have two purposes. One, known as 'monetary stability', is to ensure that the currency maintains its real value in terms of goods and services. The second, described as 'financial stability', is to make sure that commercial banks are well-run and solvent, and that deposits can be repaid in full with cash.

The Bank of England did a great job in the ten years to mid-2007 in the achievement of monetary stability. But it performed miserably in August and September 2007 when it was confronted with a classic liquidity crisis. Northern Rock – a former building society in the north-east of England – had expanded its portfolio of mortgage loans rapidly since its demutualisation in 1998. Despite the speed of its growth, Northern Rock was deemed by its auditors and regulators to be profitable and solvent in mid-2007.

However, in August 2007 it found that it could no longer finance its mortgage assets. It had become too heavily reliant on the international wholesale banking markets, which were paralysed because of the American sub-prime crisis. Northern Rock approached Lloyds TSB for alternative funding, and the two of them together then sought help from the Bank of England.

According to hundreds of textbooks, one of the means by which the Bank can and should achieve financial stability is to extend so-called 'lender-of-last-resort' loans to commercial banks with cash trouble. Unhappily, the Bank muffed its negotiations with Northern Rock and Lloyds TSB. As a run on Northern Rock's deposits developed, it was obliged to extend a lender-of-last-resort facility under duress.

The sequel was chaotic, with depositors continuing to withdraw cash and the Bank, the Treasury and the Financial Services Authority (FSA) blaming each other, more or less in public, for the shambles. The government had to step in, giving a guarantee on Northern Rock's deposits. The Treasury feared that the guarantee was unacceptable state aid in terms of EU law and required early repayment of the Bank's lender-of-last-resort loan.

Finally, in February 2008 the government decided to nationalise Northern Rock with no compensation for shareholders, even though less than a year earlier its auditors and regulators had agreed it had a book value of £2 billion. An Act of Parliament – called the Banking (Special Provisions) Act – was passed and included sections which permitted the state to expropriate a bank, if that bank would have been unviable without a loan from a government-owned entity, such as a lender-of-last-resort loan from the Bank of England. As Northern Rock could not in the autumn of 2007 have run down its mortgage assets as quickly as cash was being withdrawn at its branches, its viability undoubtedly did depend on a lender-of-last-resort loan. Here was the apparent justification for the government's seizure of Northern Rock's £2 billion of capital.

What will be the result? The answer is that British banks will avoid taking out a lender-of-last-resort loan from the Bank of England, since that could cause the shareholders to lose everything. In effect, the Bank of England has been stripped of a key traditional function and, as far as British banks are concerned, of its main *raison d'être.*

The aim of achieving financial stability might therefore be given entirely to the FSA and the Treasury. The Bank will have to concentrate on economic analysis to set interest rates and to deliver monetary stability. If so, it would no longer be 'a bank' in any meaningful sense. It would have become nothing more than a large-scale economic research department, which could be absorbed by the Treasury. As the Bank of England would no longer have any function, no one ought to mind if it ceased to exist.

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