1 NEW DEBATES ON CENTRAL BANKING

In a modern economy the central bank – the bank that has been given the monopoly right to issue legal-tender notes (or 'cash') by the state – is generally understood to have two main objectives. The first, known as 'monetary stability', is to keep the value of the notes it issues steady in terms of goods and services, so that an index of prices does not change much over time; the second is to make arrangements with commercial banks which ensure that these organisations' deposit liabilities are always convertible at par into the legal-tender notes. This second objective is termed 'financial stability', although the phrase is sometimes used more broadly to encompass the avoidance of major disturbance in financial markets.[1]

Advocacy of monetary stability goes back to the late nineteenth century. The idea of an index number originated in the eighteenth century, but those involved in public affairs took

1 In a celebrated article Anna Schwartz distinguished between 'real' and 'pseudo' financial crises, defining a real financial crisis as one in which the convertibility of deposits into currency (i.e. legal-tender notes) is widely regarded as being at risk. Writing in 1986, she said that 'All the phenomena of recent years that have been characterised as financial crises ... are pseudo-financial crises.' See 'Real and pseudo-financial crises', in Anna J. Schwartz, *Money in Historical Perspective*, University of Chicago Press, Chicago and London, 1987, pp. 271–88, reprinted in Forrest Capie and Geoffrey Wood (eds), *Financial Crises and the World Banking System*, Macmillan, New York, 1986. The quotation is from pp. 271–2 of the 1987 book.

over a century to see its implications for economic policy. They did not quickly realise that the historically favoured approach – maintaining the convertibility of paper into a precious metal, usually gold, at a fixed price (i.e. the 'gold standard') – was not the alpha and omega of monetary management. Only in the opening decades of the twentieth century did such figures as John Maynard Keynes in Britain and Irving Fisher in the USA obtain widespread support for the view that policy should be directed to the stabilisation of the prices of a representative sample of goods and services, as measured in an index number.[2] It took a further 75 years or so before a strong commitment to focusing macroeconomic policy on the stability of a price index was made by the British government. In late 1992 Norman Lamont, the Chancellor of the Exchequer, announced a regime of 'inflation targets', with inflation (according to the retail price index minus mortgage rate effects) to be kept at an annual rate of 2.5 per cent.

At any rate, between 1992 and 2007 consumer price inflation was kept with hardly any interruption at between 2 and 2.5 per cent year after year, a remarkable improvement compared with the instability of price level changes in the preceding 90 years. Moreover, the performance of output and employment was benign throughout these years, confirming Friedman's view that no permanent trade-off prevailed between inflation and unemployment. It seemed that monetary stability not only was possible in theory, but had been achieved in practice. Between 1992 and

2 Irving Fisher first put forward his proposal to stabilise the general price level in his 1911 book *The Purchasing Power of Money* (Macmillan, New York). The theme was further developed in his 1920 *Stabilizing the Dollar* (Macmillan, New York, 1920) and was taken up by Keynes in articles in the *Guardian* which were brought together in his 1923 volume *A Tract on Monetary Reform* (Macmillan, London, 1923).

1997 the Conservative government of the day worked, with the assistance and advice of both the Treasury and the Bank of England, in pursuit of the inflation target.[3] In May 1997 the Bank of England was given operational independence to meet the inflation target, with its newly formed Monetary Policy Committee taking decisions on interest rates. In the early summer of 2007 it basked in the glory of delivering on-target inflation in its first decade of independence. Since monetary stability was a fact (for the time being, at least), the Bank seemed to have done exactly what it was supposed to do. In Goodhart's words, 'the structure of the MPC, and of the subsequent Bank of England Act, was excellently designed', while 'the MPC has been extremely successful in practice'.[4]

But – just as the ink was drying on all the congratulations about monetary stability – something went badly wrong on the financial stability front. Early 2007 had been a period of strain in international money markets, because of fears that a drop in US house prices would cut the value of certain mortgage-backed and -related securities. These instruments had a wide diversity of structures and indeed of names, including 'asset-backed securities' (ABS), 'collateralised debt obligations' (CDOs) and 'collateralised mortgage obligations' (CMOs). As noted in more detail in Chapter 6, the higher-quality securities were often accorded a

3 Treasury ministers received advice from the Treasury Panel of Independent Forecasters (the so-called 'wise men'), which might be seen as a forerunner of the Monetary Policy Committee. The author was a member of the Treasury Panel from its formation in December 1992 until it was wound up in May 1997.

4 Memorandum submitted by Professor (Emeritus) C. A. E. Goodhart, in Treasury Committee of the House of Commons, *The Monetary Policy Committee of the Bank of England: Ten years on*, The Stationery Office, London, vol. II: *Written evidence*, pp. 15–19. The quotation is from p. 15.

triple-A rating by the credit rating agencies and were regarded as being easily exchangeable for the cash issued by central banks.[5] In the jargon of the markets triple-A paper of this sort was deemed – or at any rate was initially deemed – to be highly 'liquid'.[6] On 9 August 2007 three money market mutual funds run by the French bank BNP Paribas, which had been large holders of ABS, CDOs and CMOs, declared that they had heavy losses and had to suspend redemptions. By implication, the instruments – even when accorded a triple-A rating – were not as good as cash, and might be risky and illiquid. This was an unexpected shock to bank managements around the world. In the words of one money manager, echoing Donald Rumsfeld on the invasion of Iraq, '… we are discovering there are a lot more unknown unknowns than anyone thought'.[7]

In the UK all banks had been big issuers of ABS, CDOs and related securities in 2005 and 2006, but one particular category of bank – mortgage banks, including a trio of former building

5 A little more detail may be helpful. Typically, ABS and CDOs were sold as products of so-called 'structured finance'. Claims on pools of mortgage-backed (or other asset-backed) securities were split up, with one tranche having a first claim on the pool and hence little risk of default, a second tranche the next claim, and so on. Most commercial banks held only the high-quality tranches, unless they had been involved in underwriting the securities, in which case they might hold lower-quality tranches because they had been unable to find buyers.

6 The term 'liquid' is one of the most overused and ambiguous in monetary economics. The classic definition was given by Keynes in *The Treatise on Money*, where he said that among banks' assets bills are more liquid than 'investments' (i.e. government bonds) because they are 'more certainly realisable at short notice without loss' (John Maynard Keynes, *Treatise on Money*, Macmillan, London, 1930, vol. 2: *The Applied Theory of Money*, p. 67). See John Hicks, *A Market Theory of Money*, Oxford University Press, Oxford, 1989, p. 61, for an appreciation of Keynes's definition. Hicks believed that Keynes's reference in 1930 may have been the first by any economist to the notion of 'liquidity'.

7 Alex Brummer, *The Crunch*, Random House Business Books, London, 2008, p. 61.

societies, Northern Rock, Alliance & Leicester, and Bradford & Bingley – had been particularly active. The announcement from the French money market funds on 9 August caused a virtual cessation of new ABS and CDO issues, and so cut off a major source of funds for these institutions. Northern Rock's management quickly realised that a securities issue it had planned for September could no longer proceed and that over the next few months it would face serious difficulties in financing its assets. It informed its regulator, the Financial Services Authority, of its looming problem on 13 August. The subsequent shenanigans are discussed in more detail in Chapter 6.

Traditionally bank regulation had been a responsibility of the Bank of England, but that had been changed by legislation in 1998 which split the job between the so-called 'Tripartite Authorities' (the FSA, the Bank and the Treasury). On 13 September an announcement was due that the Bank of England would provide loan support for Northern Rock. The announcement was somehow leaked in advance to Robert Peston of the BBC, who proceeded to put out a 'scoop', which left viewers and listeners with the mistaken impression that Northern Rock was bust. Northern Rock's retail depositors started to pull out cash on a large scale. The momentum of the withdrawals was reinforced by the breakdown of Northern Rock's website (because it was receiving too many hits) and television pictures of queues forming outside Northern Rock branches.[8]

In these circumstances the only method of maintaining the full

8 Apart from Brummer's excellent narrative account of these events, there are the Treasury Committee's report, *The Run on the Rock*, referenced in the next footnote, and an insider version, Brian Walters, *The Fall of Northern Rock*, Harriman House, Petersfield, 2008.

convertibility of deposits into cash was for Northern Rock to draw on its loan facility at the Bank of England. Later Northern Rock was described, notably by the Bank's governor, Mervyn King, as 'reckless' in its reliance on the *wholesale* funding of its mortgage assets.[9] In fact, a major counterpart to the Bank's loan to Northern Rock, which eventually reached about £30 billion, was a collapse in its *retail* deposits (see Table 1). Most serious analysts, backed up by comments from the UK's senior bank regulators, agreed that Northern Rock's mortgage assets were of good quality, and that eventually the bank ought to be able to repay its deposits and wholesale liabilities. By implication, the blame for the first big run on a British bank's deposits lay heavily with incompetent handling of the crisis by the Tripartite Authorities in August and September 2007. Whereas the Bank of England's achievement of monetary stability was impressive, there had been a clear failure in the delivery of financial stability.

Table 1 The hole in Northern Rock's balance sheet

At 31 December 2007 Northern Rock owed £28.5 billion to the Bank of England, whereas a year earlier it had owed the Bank nothing. In terms of counterparts, the loan had been necessitated by three developments.

	£ billion
Increase in Northern Rock's assets	8.8
Decrease in retail 'customer accounts'	15.3
Decrease in other liabilities, mostly wholesale	4.4
Total of three developments	28.5

Source: Northern Rock reports and accounts

9 See the evidence given by King and Professor Willem Buiter, as summarised on p. 18 of vol. 1 of the Treasury Committee's *The Run on the Rock: 5th report of session 2007/8*, The Stationery Office, London, 2008.

Since modern Britain was unfamiliar with bank runs, politicians, commentators, journalists and even bankers themselves were unsure about the appropriate policy response. One feature of the situation that was new, conspicuous and unexpected was the Bank of England's large loan to Northern Rock.[10] Since the Bank of England had been owned by the state since its nationalisation in 1946, the loan was widely characterised as 'government money'. A recurrent theme in media coverage was that 'Northern Rock is receiving government money', as if the Bank's loan to Northern Rock were analogous to public expenditure on education and health. According to John Kay in his column in the *Financial Times*, writing in July 2008, 'Still the bills roll in. Taxpayers have already written impressively large cheques for Northern Rock ...'[11] This notion was often associated with the allegation that the government was prepared to dole out money to help 'The City', but that it was mean towards nurses and teachers, whose pay increases were being restricted as part of the larger effort to curb public expenditure.

10 In nominal terms the Bank of England's loan to Northern Rock was unprecedented in terms of size. Its exposure relative to risk in the private sector, however, was not unprecedented relative to GDP. As noted by Bagehot in *Lombard Street*, the Bank of England's loans on 'private securities' jumped in the 1866 crisis from £18.5 million to £33.4 million. Total advances on 'proper security' in the same crisis were claimed by the Bank itself to amount to £45 million. With GDP in 1866 estimated at £966 million, the 1866 credit extensions were therefore between 1.5 and 4.5 per cent of GDP, equivalent in today's terms to just over £20 billion and just under £65 billion. Walter Bagehot, *Lombard Street*, vol. IX in Norman St John-Stevas (ed.), *The Collected Works of Walter Bagehot*, The Economist, London, 1978, originally published in 1873, pp. 78, 132, and B. R. Mitchell, *British Historical Statistics*, Cambridge University Press, Cambridge, 1988, p. 836. The secondary banking crisis in the mid-1970s also exposed the Bank of England to large possible losses.

11 John Kay, 'Fannie Mae and the limits of public obligation', *Financial Times*, 16 July 2008.

The media hubbub was mostly silly, but the Northern Rock affair did raise wider issues. In particular, a basic question for future public policy was 'how should the state organise the regulation of banks and the financial system to prevent a repeat of the Northern Rock fiasco?' To some observers the cause of the run in September 2007 was the low level of deposit insurance in the UK. On this view retail depositors pulled their money out of Northern Rock because they were certain of receiving back 100p in the £ only on the first £2,000 of deposits. On the next £33,000 they would receive back only 90p in the £ and on sums above £35,000 they were, in the extreme, liable to lose the entire amount deposited. Given the alarmist tone of the Peston leak on 13 September, the rush to withdraw money over the next few days was rational, even if misinformed and unnecessary.[12] The answer seemed to lie in improved terms for deposit insurance. This was certainly one message in evidence given by King to the Treasury Committee of the House of Commons on 20 September. The Committee's report, *The Run on the Rock*, which appeared in January 2008, duly emphasised the position of depositor protection in the British financial system and recommended 'the establishment of a Deposit Protection Fund to be funded by participating institutions'.[13]

12 The usual reference here is to a classic article by Diamond and Dybvig, which shows why an individual depositor is rational to withdraw funds from a bank he believes to be solvent, if he also believes that other depositors will withdraw funds on a large scale before him (Douglas W. Diamond and Philip H. Dybvig, 'Bank runs, deposit insurance and liquidity', *Journal of Political Economy*, University of Chicago Press, Chicago, 91(3), 1983). The Diamond and Dybvig article provided a scholarly case for deposit insurance and argued that lender-of-last-resort assistance to banks created problems of moral hazard in their asset selection. The same themes appear in Mervyn King's speeches.

13 Treasury Committee, op. cit., vol. 1, p. 118.

Concern was expressed that, even if depositors eventually received 100p in the £, they might get their money back only after a delay. In order that such delays could be avoided, the argument was heard that the Deposit Protection Fund should be financed in advance. This raised several new questions, however, notably how the 'participating institutions' were to raise the funds that were to be injected into the Deposit Protection Fund. In June 2008 King spoke at the British Bankers' Association annual conference and proposed to the 350 delegates that 'Some element of pre-funding is natural'.[14] Since the banks were at the same time trying to raise capital on the stock market by rights issues, the suggested requirement to pre-fund a new scheme (which would absorb some of the rights issue money) was unwelcome to them, to say the least. One result was a further deterioration of relations between King and leading bankers.

By the summer of 2008 relations between the Bank of England and Britain's banks had never been worse. The tensions were aggravated by the strong resentment felt – in both the Treasury and the Bank of England – at the wide disparity between their own public sector salaries and the often fantastic incomes earned by leading figures in the banking industry. Influential journalists, such as Martin Wolf, the chief economic commentator on the *Financial Times*, urged that financial regulators ought to introduce controls on bankers' pay. In April 2008 the Institute of International Finance, said to represent 375 of 'the world's largest financial companies', responded to public hostility by acknowledging that banks had taken too many risks and paid excessive

14 Christine Selb, 'King clashes with banks by urging advance funding of compensation', *The Times*, 11 June 2008, and Christine Selb et al., 'Banks may be forced to pump billions into savings compensation scheme', *The Times*, 30 June 2008.

bonuses.[15] Banks' requests for help from the Bank of England, and their resistance to extra imposts such as the advance money for the Deposit Protection Fund, were seen as special pleading. Along with the allegation that Northern Rock had taken up scarce 'government money', numerous media reports represented the banks as greedy and inefficient.

The crisis reached a new level of intensity in September and October 2008. By then the leading British banking groups had announced their results for the first half of 2008, and all of them were profitable and solvent. Nevertheless, the Tripartite Authorities got it into their heads that British banks were undercapitalised and at risk of 'going bust'. The banks were dragooned into a recapitalisation exercise, in which they were forced to sell preference shares to the government at an interest rate of 12 per cent. (In mitigation, it has to be said that similar programmes of bank recapitalisation were organised in other countries, but nowhere was the government as vindictive towards the banks as in the UK. In the USA, where several banks were indeed close to insolvency and actually insolvent, the government also bought bank preference shares in a similar recapitalisation programme, but it charged only 5 per cent.)[16]

The prime minister, Gordon Brown, somehow managed to persuade the media that bank recapitalisation, for which he

15 Krishna Guha and Chris Giles, 'Blame us for crisis, say leading bankers', *Financial Times*, 10 April 2008.

16 The issuance of preference shares to the state by banks in difficulty is not new. It was adopted in the USA by the Reconstruction Finance Corporation from 1933, to help in the recapitalisation of the US banking system. The point was noted in the author's article 'There is nothing magic about this Keynesian fad', *Spectator*, 25 October 2008. The issuance of preference shares by the finance ministry could be regarded as a kind of lender-of-last-resort loan, although it does not come from the central bank.

took personal credit, was a masterstroke. It certainly pandered to widespread anti-bank sentiment in the chattering elite. Media opinion has to some extent already translated into legislative and regulatory action, such as the 2008 Banking Reform Act, which will in the first instance damage bank profitability. The effects in the longer run will include a rise in the cost of banking services to companies and individuals, and the transfer of internationally mobile banking activities from the UK (particularly from London) to other countries. Given the contribution that financial services have made to economic growth in the UK over the last 40 years, this relocation of activities may prove a national disaster. Historically, the Bank of England had a friendly and cooperative relationship with Britain's banks, and this was one factor in the competitiveness of the City of London relative to other financial centres.

The purpose of this study is to argue for a redefinition of the Bank of England's position in the British financial system, in order to improve its delivery of financial stability. An underlying theme throughout will be that many of the Bank's traditional and established arrangements, jettisoned over the last decade, often for no clear reason, had a strong functional rationale. In his evidence to the Treasury Committee on 20 September, King offered his perspective on the Northern Rock run. The thrust of his remarks was that direct measures of deposit protection, including the expansion of deposit insurance already mentioned, should have more prominence in the pursuit of financial stability than in the past. By contrast, he had little to say about the Bank's work as lender of last resort. Implicitly, the lender-of-last-resort role was to be demoted. In its report about *The Run on the Rock* the Treasury Committee devoted just one page to the lender-of-last-resort function of central banks, compared with a full chapter of sixteen pages and much other material to deposit protection. Even this page damned by faint praise, opining that – because the publicity arising from the announcement on 14 September had damaged depositors' confidence in Northern Rock and so sparked the run – 'the level of stigmatisation now attached to [a lender-of-last-resort] facility is such that its effectiveness must be in doubt'.[17]

The argument of this study will be that, on the contrary, the Bank of England's responsibility to act as lender of last resort – its responsibility, in other words, to lend to solvent banks when they are short of cash – is one of its defining tasks. Arguably both deposit insurance and last-resort lending have a role, and a balance has to be struck over their relative weight in financial regulation. The emphasis here is on the advantages of the lender-of-last-resort role and the disadvantages of deposit insurance. The implications for the Bank of England's structure are drawn out in Chapter 7, which includes the radical recommendation that it ought to be privatised if it is to be most effective in the delivery of financial stability.

The correct specification of the central bank's lender-of-last-resort role has been controversial since the term was first used by Sir Francis Baring in 1797. The classic formula, given by Walter Bagehot in his 1873 *Lombard Street*, was that in a crisis the central bank should lend at a penalty rate without limit against good collateral. The Bagehot principle will be reviewed in Chapter 5 and King's attitude towards it is discussed in Chapter 6. But an account of the development of banking and central banking, and an explanation of how the wider economy benefits from increased

17 Treasury Committee, op. cit., vol. 1, p. 86.

financial intermediation, is needed first. These form the subject matter of the next three chapters.

The author of this study is probably best known as an advocate of monetary control to reduce inflation. Apart from a brief reference to the risks of debt deflation in Chapter 7, the subject of monetary stability is not explicitly considered. No elaborate reasoning is necessary, however, to defend the proposition that a nation with a stable financial system is far more likely to enjoy monetary stability than a nation where the banks are footballs in the political debate, and can be kicked around at the whim of politicians, civil servants and newspaper columnists.

This study is illustrated mostly by events that have happened in the UK. It is hoped that – with a little tweaking of names, dates and phrases – the analysis of central banking presented here is relevant to almost any country.