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Introductory

At the end of the 1970s, the Bank of England was a microcosm of the UK. It was steeped in history, but at the same time deeply confused about its identity and quite inconstant in its performance. Within a quarter of a century, both the country and the Bank changed. The country became modern – with the subsequently widely derided slogan of 'Cool Britannia' – and so did the Bank. By the beginning of the 2000s, the Bank of England exemplified what was then thought to be the best practice of a modern central bank, running a clearly defined rule-based system based around an inflation target. The UK became more dynamic but more questioning and cynical. A country that was being transformed and opened up demanded more explanations of its political leaders. The Bank needed to add open mouth operations to its open market actions.

The changes can be described as an informational revolution, but also as part of a broader process of globalization: there was much more awareness of international activity and of how the UK was affected by what went on beyond its frontiers. Paul Krugman thinks that the Bank of England punches internationally above its weight not because of the strength of the British economy but because of its 'intellectual adventurousness'.[1] At the outset of a previous volume of the Bank of England's history, Richard Sayers started with the remark that the Bank of England in the last generation before 1914 was 'not a central bank according to the mid-twentieth century usage of this term'.[2] He told a story of evolution. In a similar way, the late 1970s Bank of England was far from being a central bank as the late twentieth century understood it. But it became one.

A modern central bank has a much narrower and more limited set of tasks or functions than the often historic institution from which it developed. The objective is the provision of monetary stability, nothing more and nothing less. In order to achieve that goal, it is essential to observe and

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use policy instruments to respond to macro-economic aggregates, price and wage behaviour and financial activity. The old type of central bank would intervene directly and specifically in all these areas; the modern bank relies on economic agents to respond predictably to monetary signals. The aim of a prudent path is to prevent false inferences and dangerous gambles on an uncertain future. The central bank is a certainty- and confidence-generating institution that lives up to the maxim of Titian's Allegory of Prudence. There was a conceptual break as to how that prudence might be realized. Before, the central banks were promiscuous, dabbling everywhere; after, they were mono-maniacal about their fixation on the new goal. The new central banks also believed that the new simplification of their task made them more clearly and transparently accountable to a larger political process. By the early 2000s, when this account comes to an end, that task looked as if it had been achieved with stunning success, and a hubris of central banks (and of the economics profession) ensued. The financial crisis after 2007–2008 was a nemesis, a demonstration that life, and economics, was more complicated. The creation of the new central bank took place in the late twentieth century as a response to major shocks that did not look as if they could be treated by the vast panoply of the bank's traditional mechanisms. Those shocks are the subject of this volume, and include the inflationary shocks of the 1970s, following from a mixture of government fiscal policy (fiscal dominance in modern parlance), poor management practices in the UK, external shocks (in particular the oil price increases), financial openness and globalization from the 1980s, and the strains arising out of both international and European efforts at exchange rate coordination and control. All these turbulences produced messy and unclear signals, and made it hard to calculate the core concept of modern central banking theory and practice, a clearly articulated reaction function that could be generally understood by every participant in the economic process.

The Bank of England, established by an Act of Parliament of 1694, is an old central bank, second only to the Sveriges Riksbank (Imperial Bank) in its antiquity. The names of those old institutions were quaint: Sweden no longer has an empire; the Bank of England is also the central bank for Scotland, Wales and Northern Ireland. Walter Bagehot, the great editor of the *Economist*, who explained much of the modern theory of central banking in *Lombard Street* (1873), also observed, in *The English Constitution*, published six years earlier, that: 'The most imposing institutions of mankind are the oldest; and yet so changing is the world, so fluctuating are its needs, so apt to lose inward force, though retaining

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outward strength, are its best instruments, that we must not expect the oldest institutions to be now the most efficient.'[3] The story of the years covered in these pages is a struggle over what efficiency and effectiveness meant. A large part of that struggle involved shedding a strongly entrenched idea about British peculiarity or British exceptionalism and learning from the rest of the world: at first, in the late 1970s and 1980s from US and European debates about monetary targeting, then later in the 1980s from Europe, with the result that an exchange rate anchor was seen as the cornerstone of credibility; and then, in the 1990s, from elsewhere, with an inflation target imported on the basis of New Zealand's pioneering experience. In the 1960s, the economist Fred Hirsch opined that 'while these foreign central banks have had a mixed record in adjusting their economies, they seem to be notably better adjusted themselves, in the psychological sense'.[4] Central bankers communicated in this period much more across national frontiers than they had in the thirty years after the Second World War. In the mid- to late twentieth century, the Bank maintained many institutional arrangements that looked quite exceptional, with no parallels in other central banks. The provision of liquidity to the banking system, for example, which in the US went through an open market trading desk, in Threadneedle Street required a procession of money brokers dressed in top hats. By the twenty-first century, the Bank was obviously a very global institution: for the 2012 London Olympic Games, it set up a map in its cafeteria showing the countries of the world of its employees, with virtually no country unrepresented; and from 2013 its Governor was a no-nonsense Canadian citizen who regularly appeared in the staff cafeteria as well as in the gym. His predecessor, Mervyn King, had liked to interact with Bank economists, and encouraged them to call him 'Mervyn'.

The 1980s and 1990s in fact marked a fundamental change in thinking about central banking all over the world. The new approach was driven by the social and political disruption that followed from high levels of inflation – from what was often termed the 'Great Inflation' of the 1970s, when inflation had soared all over the industrial world, but when the UK rates were higher than in any other industrial country. The practice of the central banks that delivered a better inflation performance – especially Germany and Switzerland – looked like an attractive model for emulation. The practical lesson began to have a theoretical or academic underpinning. An insight into the problem of time-consistent policy demonstrated that an independent central bank could deliver a superior performance as it was not subject to short-term political pressures to give an inflationary boost.[5]

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The theoretical result was supported by a large amount of empirical data on the lower inflation achieved by independent central banks.[6] In consequence, the accepted international best practice for central banks meant the ability to determine monetary policy, based on a low inflation target set through a political consensus.

Accounts of how central bank independence affected market decisions rested crucially on how market participants reacted to their perceptions of central bank actions. In consequence, central banks needed to change the way they dealt with their audiences. In the 1990s, Eddie George as Governor appeared on television. He had already been quite effective in this medium as Deputy Governor, when the Bank's media advisers believed that the then Governor would be counterproductive because of his patrician manner. The chief economist (and eventually George's successor) Mervyn King emphasized clear and simple communication, and initiated an expansion of the Bank's publications and communications, most importantly in the presentation at press conferences of the Inflation Report. He argued that the Bank should 'forsake mystique and mumbo jumbo for transparency and openness'.[7] In the aftermath of the financial crisis of 2007–2008, the Bank felt that it needed to go further to draw the full consequences of the information revolution. It was crucial to communicate clearly and effectively with the general public, whose choices and behaviour would ultimately affect output, consumption and price behaviour.[8] The Bank now started to worry about the complexity of language in its reports and in the speeches of its officials, and it now went beyond simply speaking to the 'markets' or the financial community.

From the late 1990s, the Bank of England generally featured high in comparative academic rankings of central bank transparency – along with the even older Sveriges Riksbank and the Reserve Bank of New Zealand. In 1997–1998, in the new legal framework created by the 1998 Bank of England Act, it was the leader: others then emulated and caught up.[9]

At the outset, the Bank – and central banks in general – were secretive and functioned behind multiple veils: of language, of statistics, even of location. Hirsch commented on 'the over-riding concern for appearance and form that hits every visitor who enters the fortress doors of Threadneedle Street, and goes on hitting him the deeper he penetrates into the Bank parlours'.[10] The Bank's seclusion was reflected in the physical architecture. The Bank of England's main building – as elaborately

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reconstructed in the 1930s – was blocked off from the outside world. The only visible part of the great eighteenth-century bank designed by Sir John Soane that survived was the austere outside wall, intended as a defence against attack by the people, in the aftermath of the Gordon riots. When it was rebuilt in the 1920s and 1930s, the architect Herbert Baker stated that he wished his design to embody 'the three values of efficiency, conservatism, and architectural expression'. He asked the directors of the Bank what their institution stood for and was told: 'Not the amassing of money, but rather that invisible thing, Trust, Confidence, which breeds Credit; it is by these "starres not to be told" that London regained her position as the nerve centre of the world's finance when it might have been lost after the Great War.'[11] By contrast, in the twenty-first century, central banks conceived of themselves in a different way. In 2005, the European Central Bank (ECB) chose a design by Coop Himmelb(l)au that in the view of the ECB Council 'reflected the ECB's values and translated them into architectural language'. The competition brief had specified that the new premises should 'foster interactive communication' and 'promote teamwork'.[12] The design concept was intended to reflect the ECB's 'transparency, communication, efficiency and stability'.[13] Did the Bank of England fully move along in this direction, and could it? There were some architectural adjustments, and as Deputy Governor in the early 2000s David Clementi supervised the knocking down of partition walls and the creation of large open plan offices. Especially after the Global Financial Crisis, all the old objections came back. The Governor appeared, in the words of Labour Chancellor Alistair Darling, like 'some kind of Sun King around whom the court revolves'. Deputy Governor Sir John Gieve suggested that the Bank is 'a monarchy and always has been – sometimes constitutional, other times autocratic': and Darling viewed it as 'an autocratic fiefdom of the Governor, which is anachronistic'.[14]

Communication in particular became the central concern of the new philosophy of central banking. The modern representatives of the Bank of England repeatedly emphasize that they have 'come a long way' from the alleged motto of Montagu Norman: 'never explain, never excuse'.[15] Actually, this is unfair, and represents a distortion of the real history. There is no evidence that Norman ever used this phrase, which is first put into his mouth in a thoroughly unreliable biography by Andrew Boyle.[16] Even in the interwar period, explaining was important. When Norman appointed Henry Clay as his economic adviser in 1935, he told Clay, 'Let me tell you that you are not here to tell us what to do, but to explain to us why we have done it.'[17] On the other hand, it is true that

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unarticulated feelings and understandings were at the heart of the Bank's practice. As Norman told the Macmillan committee: 'Reasons, Mr Chairman? I have no reasons, I have instincts.'[18]

MONEY AND BANKS

Central banking clearly had to do with money and banks, and the evolution of the Bank went alongside an evolution of monetary theory. In one account, the fundamental function of a central bank was the issue and control of money; in another it was the management of a banking system that generated money through credit. There was a real problem lying behind the lack of statutory clarity. No one really knew precisely what either money or a bank was. But they were clearly linked, and banks provided a way of making money – a dangerous and potentially deadly way, as Adam Smith had pointed out in the famous metaphor of the Daedalian wings, which he introduces in the *Wealth of Nations* (1776) immediately after he describes the founding of the Bank of England:

> The gold and silver money which circulates in any country may very properly be compared to a highway, which, while it circulates and carries to market all the grass and corn of the country, produces itself not a single pile of either. The judicious operations of banking, by providing, if I may be allowed so violent a metaphor, a sort of waggon-way through the air, enable the country to convert, as it were, a great part of its highways into good pastures and corn-fields, and thereby to increase very considerably the annual produce of its land and labour. The commerce and industry of the country, however, it must be acknowledged, though they may be somewhat augmented, cannot be altogether so secure when they are thus, as it were, suspended upon the Dædalian wings of paper money as when they travel about upon the solid ground of gold and silver. Over and above the accidents to which they are exposed from the unskillfulness of the conductors of this paper money, they are liable to several others, from which no prudence or skill of those conductors can guard them.[19]

Rival interpretative traditions see the tasks of central banks in contrasting ways. A version that goes back to Walter Bagehot and continues through John Clapham, Ralph Hawtrey and Theodore Gregory to Charles Goodhart sees central banks as designed to produce one fundamental public good, financial stability, through lender of last resort operations.[20] An alternative way of thinking, best encapsulated by Curzio Giannini, is that the basic good was the provision of money and the maintenance of a payments system.[21]

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Money. When the 1694 or the 1844 acts were drawn up, there was no doubt in anyone's mind that what was referred to was metallic money. The 1694 act was accompanied by a far-reaching monetary and coinage reform, overseen by Isaac Newton as Master of the Mint, and indeed that step rather than the establishment of the Bank was the initial foundation of British monetary stability. The Great Recoining established a currency that was protected by milling from the abuse of clipping. It was extremely costly, as the Mint bought in low-weight coins at face value; but the expenditure amounted to an investment in credibility. Confidence in the Bank of England was finally established when in the aftermath of the Napoleonic wars, and the abandonment of convertibility in 1797, the equivalence of banknotes and gold was restored in 1817.

But the certainty of the old Bank had been destroyed by the abandonment of the gold standard in September 1931, in the middle of the maelstrom of the Great Depression. A. J. P. Taylor's celebrated *English History 1914–1945* has this event as the turning point, the 'end of an age': 'A few days before, a managed currency had seemed as wicked as family planning. Now, like contraception, it became a commonplace.'[22] It was the departure from gold that made modern monetary policy a possibility. Modern accounts mostly emphasize the new room for monetary autonomy as the reason why Britain's experience of the 1930s was much more positive than the dismal 1920s.

To continue, perhaps impermissibly, Taylor's analogy, the managers were not very proficient with the new techniques, and like contraception, monetary management often failed (but generally over time became more reliable). The ensuing debate is the major subject of this book. It was tense and mostly unproductive. Mervyn King, chief economist (and eventually Governor), later lamented 'the striking fact' that 'as economics have become more and more sophisticated, it has less and less to say about money'.[23]

The story of the Bank's debate about money began with confusion, and ends with inflation targeting. The June 1977 *Quarterly Bulletin* stated: 'It is too soon to make a definitive judgement about the usefulness of monetary targets and how they should be operated.'[24] The Bank's historian Forrest Capie concludes his survey of monetary policy debate at the end of the 1970s with the remark: 'It is not really clear what the Bank's view on monetary control was. There were differences within the Bank and changing positions.'[25] A battle took place over which monetary aggregate best represented the idea of 'money'. Inflation targeting was successful in

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anchoring inflation expectations, but it also was no complete panacea: it solved one problem, but created a new dilemma. A large monetary and credit expansion might occur without price inflation, but where monetary behaviour was rather reflected directly primarily in asset prices, and where in consequence the development posed a potential threat to financial and, more generally, to economic stability. The discussion of financial stability raises the question of the Bank's attitude to banks.

Banks. The 1946 act gave no help in saying who a banker (or a bank) was. This issue is still unresolved, as one of the consequences of financial regulation is the emergence of banklike activities (shadow banking) outside the regulatory regime. The 1946 act simply stated: 'The expression "banker" means any such person carrying on a banking undertaking as may be declared by order of the Treasury to be a banker for the purposes of this section.' Gordon Richardson liked to resolve the issue by saying that banks were like elephants: you recognized one when you saw it.[26] In practice, banks to the Bank of England meant the merchant banks and clearing banks that had accounts with the Bank. There were other banks, but they only obtained legal clarity through the 1967 Companies Act, which, in Section 123, allowed the Board of Trade to issue a certificate to firms 'bona fide carrying on the business of banking for purposes of the Moneylenders Acts 1900–1927'. After that, there were 'objective criteria' for such banks, including a minimum capital (£250,000) and the provision of current and deposit account services.[27] In 1973–1974, the eruption of the 'secondary banking crisis', when the Bank of England needed to provide some £120 m for rescues of financial institutions, showed that these smaller institutions might indeed pose a systemic risk. The delayed legislative response to the 1973–1974 failures, also driven by the first European Community Banking Directive of 1977, was the 1979 Banking Act. The new legislation introduced a two-tier system of recognized banks and licensed deposit takers. Both were subject to supervision and surveillance by the Bank of England, but the higher-level superior (recognized) banks were inherently trusted – a trust that proved quite problematical over the next years.

The British banking and financial system was in fact highly segmented at the beginning of the period considered here. There were the large clearing banks, which had been grouped in a cartel until 1971, and which had long maintained balances at the Bank of England and worked with the Bank in clearing transactions. Unlike continental European banks, they did not engage in long-term lending or holding industrial securities: they generally lent on overdraft or at most for a two-year term. They thus did not really do

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profound or long-term maturity transformation. There were discount houses, which took on the treasury (cash management) functions of the clearing banks. There were accepting houses, merchant banks which dealt primarily in foreign trade finance and which guaranteed bills through their signature (acceptance) and, in this way, made the bills useable in the money market. There were building societies, which handled consumer mortgage finance funded through customer deposits. There were finance companies, which specialized in consumer lending for hire purchase and which often funded themselves through credits from the clearing banks. The segmentation made the London market 'respectable', 'orderly' and safe.[28] The British system became the envy of the world: 'Possibly the British banking system did find the holy grail of financial stability without sacrificing the contribution it made to savers, borrowers, and the economy as a whole.'[29] From the 1970s, and much more rapidly in the 1980s, these old distinctions started to break down. Clearing banks began their own treasury operations, often on the Euromarkets in foreign currencies, and moved into the mortgage business. The discount houses were undercapitalized, and handled smaller shares of the clearing banks' money business. Some tried to expand into new areas of business. The accepting houses in the 1980s teamed up with large banks, sometimes British, but in most cases foreign. The building societies competed with banks in lending, and under the 1986 Building Societies Act were allowed to demutualize and become banks themselves. The 'orderly' quality of the London system eroded, and a new City came into being.

From the point of view of the Bank of England, dealing with money and with banks required a quite different organizational and managerial structure for both cases. Money needed a clear overall policy, clearly articulated and communicated. The Bank could not afford to speak with multiple voices. There was a premium on consistency and discipline. But in the late 1970s and early 1980s, the Bank often behaved as a talking shop, and one that was unguided by any consensus on what constituted professional economic expertise. When the government after 1979 started to formulate a policy based on monetary targets, different senior Bank officials disagreed with that policy in different ways. Banking regulation and supervision, on the other hand, required a large number of line managers paying attention to the details of the particular banks for which they were responsible, and quickly communicating their doubts and anxieties. Each bank had its own very individual problems, but also interacted with other institutions in a web of market transactions. But in the 1970s and the 1980s, the Bank was much too hierarchical for such communication to be easy, and in

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consequence the Bank appeared to 'miss' one problem case after another, Johnson Matthey, BCCI, Barings. In reality, it got the broader financial stability issues right, and there was never in the period covered here any prospect of a general threat like 1931 or even more devastatingly 2007–2008. The Latin American debt crisis might have developed into a general world crisis, like 1931, but was well handled by central banks, and the Bank of England played a major role in building an effective response. But because the Bank could not communicate well, not many people noticed the major success and everyone pounced on the smaller-scale failures.

The different management issues or problems of the different Bank functions inevitably affected the conduct of Bank officials. No one was ever sacked or even discredited within the Bank for espousing the 'wrong' view on monetary policy, although targets were not met and the formulation of targets was profoundly flawed. A possible exception is Andrew Crockett, who might have been sidelined because of his views on exchange rate policy. The Bank was not unique in this way: no Fed official has been straightforwardly fired for a mistaken approach to monetary policy – though Arthur Burns, who gave in to President Nixon's political pressures in the Great Inflation, was not reappointed by President Carter. In part the failure to punish monetary error is a product of the fact that economics is rarely black and white, and even long-discredited theories such as the highly influential nineteenth-century real bills doctrine (that central bank issue should be issued on the security of sound commercial bills) actually may be good policy guides in some circumstances. But, by contrast, supervision of banking is full of pitfalls. Middle-ranking Bank of England officials did lose their jobs because of mistakes in banking supervision. In addition, supervision took on many rather demoralized and disgruntled employees who had previously worked in exchange control, and brought little enthusiasm into their new specialization. The result was an obvious response by young and ambitious officials: money was both more intellectually prestigious and less professionally unsafe. In the 1970s, the most dynamic area of the Bank seemed to be the Overseas Department and then the International Division, and, then, in the 1980s Markets became the hot part of the Bank and in the 1990s Monetary Analysis. Going into the banking supervision side of the Bank was consequently an unattractive and unrewarding career move.

After 1979, the demands on the Bank both in terms of monetary policy and in terms of banking supervision changed. The year 1979 can be thought of as a major caesura. This is not just the case with central banking and finance. Some analysts – including the present author – think of the

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