

“How the central bank supports the wealth of the nation”

Speaker: Sir John Gieve, Deputy Governor of the Bank of England

Date: Tuesday 13th March 2007

Chris Skinner welcomed Sir John to one of the club's dinners, whose format is to hear from the speaker before enjoying a dinner and continuing the discussions.

How did the Bank come about?

Sir John explained that the BofE was set up by a Scottish speculator. The Bank has been through turbulent times and in its past it might have gone under. We were shown a cartoon of Pitt raiding the old lady of Threadneedle Street for gold and issuing promissory notes instead. The Bank was a private company until it was nationalised in 1946. The staff of the bank had always seen themselves primarily as bankers not as part of the state.

What has been the Bank's traditional role?

The Bank evolved as head boy of the city. It saw its business as getting the city of London to behave well. The Bank had an assumed role of informal leadership until the late 1970s – it was part of the club style of the city. With the secondary banking crisis of the 70s its role changed to that of a statutory responsibility. Its role is defined in statute but it is not part of government.

What is the Bank now responsible for?

The Bank's MPC, Monetary Policy Committee sets interest rates. Its prime responsibility is to hit its inflation target. In the 90s it lost its City supervision role to what is now the FSA and gained instead the impact control of economic policy.

What has been the operational progress?

We were shown a graph of real GDP against inflation going back some 30 years. There is now shown to be a close match, whereas in the 70s there were wild swings as interest rates were a purely political mechanism. This led to a number of crisis cumulating in the ERM fiasco after which it was concluded a better mechanism was essential for stability. There has been a quantum leap in the professionalism applied to setting rates, which with the establishment of the MPC has been liberated from purely political control.

What has helped maintain stability?

The growth of China with its cheap manufacturing capability has helped keep prices down. Recent small rate increases are designed to stop underlying pressures affecting inflation and to damp down inflation pressures. There are signs of continued growth in the economy with Europe now performing better than for some years.

Are there threats to stability?

There was a market wobble at the end of Feb 2007. We were shown a graph of volatility in equity indexes. Is this just a blip or the portent of more turbulent times? There has recently

been spectacular falls in derivatives of the ABX index for sub prime mortgages. These started in January. Only when people start defaulting in numbers does the market seem to react. One might think professionals would react ahead of this. Thus they are worried about delays in reactions.

What is the Bank's role in financial stability?

This role for the Bank developed in the 19th century where it became lender of last resort. The Bank continues with this role which does not mean it guarantees lifelines irrespective of circumstances e.g. Barings.

The Bank has a big role in improving relations with overseas authorities for either financial crisis management or operational crises such as 9/11.

What is likely to be coming up in the near future?

There is a financial stability report due out in April. A financial crisis would more likely occur in loss of liquidity in the wholesale rather than the retail markets.

What has been the impact of new products?

Banking has been changing with the growth of Credit Derivatives, which is seen as a positive for financial stability – but risks have been low and markets stable. There is not enough knowledge of how new products and new markets will behave in the event of severe adverse circumstances, so we have to worry about them.

What sort of crisis might there be?

If there is a crisis in London it will be International. London's % share of various categories of global business is now significant.

How is London's position doing?

The FSA is getting great press as a single, respected and responsive regulator, sympathetic to the industry it is regulating. Industries tend to cluster around pools of skills which in turn enable innovation and growth. London can still grow a long way. The European national markets are only slowly breaking down. Outside of the USA and UK the growth of capital markets is only in its infancy. There are a hundred ways we can spoil the position but if we don't there is plenty of scope for further growth.

What else does the Bank do and should its role be further changed?

The Bank has a secondary target to support the government's economic plan once the primary inflation target is met. Should the Bank's role be changed further? Sir John's view was no. The change from RPI (Retail price index) to CPI (Consumer price index) has not been easy and there seems no appetite for more change. The MPC is the culmination of 20 years of real pain and three recessions. Its ongoing challenge is to avoid these painful economic circumstances in the future.