State of Play

14 October 2021

Our Investment Specialist, Simon Durling, shares his thoughts in our latest update. Central banks have played an increasingly important role in modern times especially during the recent global pandemic and financial crash of 2008. State of Play looks at their changing role and why they remain so important to maintain a stable financial system that consumers, borrowers, savers and investors can rely on.

The financial world we know today with all its complexities was many centuries in the making. Evolving and adapting through wars, revolutions (be they religious or industrial) and now into the fully fledged digital era which has accelerated change at a breath-taking pace. One aspect of our current financial framework that can be recognised across much of this period of evolution is the idea of a central bank. Whilst these institutions operate slightly differently from one another depending on the country they represent, their primary task is to ensure monetary and financial stability, liquidity and governance over the financial foundations which we often take for granted. Why were they created? Why are the forecasts they make (and the way they talk about them) so important to consumers, savers and investors?

Central bank idea is born

The Bank of England (BoE) cannot claim to be the oldest central bank in history (that honour goes to the Riksens Ständers Bank in Sweden), but its formation, influence and structure helped forge the birth of an empire and the model to which most of the central banks formed in this era were based. Towards the end of the seventeenth century England had suffered a heavy defeat to France, the dominant naval power at the time, at the Battle of Beachy Head (1690). King William III and Queen Mary's government needed to rebuild both the economy and, importantly, their navy to compete on the world stage. However, they were short on funds and had what in today's terms would be described as a poor credit rating - making borrowing almost impossible. Charles Montagu, the 1st Earl of Halifax, using an idea first proposed by British Economist William Paterson three years before, founded in 1694 'The Governor and Company of the Bank of England' in order to raise share-capital and lend it to the UK Government in return for an 8% interest charge. The UK Government would guarantee the loan and any national debt, through the Tonnage Act, by raising taxes on shipping and alcohol.

It began as a private bank that would act as a banker to the UK Government. The original Royal Charter of 1694, granted by King William and Queen Mary, explained that the Bank was founded to 'promote the public good and benefit of our people'. The BoE opened for business on 1 August 1694 in temporary accommodation in the Mercers' Hall in Cheapside, London. It had a staff of just 17 clerks and two gatekeepers. It raised the £1.2 million in just 12 days using half of the capital raised to rebuild the naval fleet. The additional economic benefit was the massive industrial effort required in establishing new ironworks to make more nails and the advances required in agriculture to help feed the quadrupled size of the navy helped grow the economy and with it the nation's wealth and influence.

The Old Lady of Threadneedle Street

The BoE moved to its current location on Threadneedle Street in 1734, standing on an island site covering 3.5 acres surrounded by huge walls. The underground vault, which contains more space than a large office block, holds the gold reserves of the UK and many other countries making it one the largest stocks of gold bullion in the world. It is referred to as the 'The Old lady of Threadneedle Street' which was taken from a cartoon by James Gillray in 1734 depicting the then Prime Minister, William Pitt the Younger, wooing an old lady – who represents the BoE, but his true intention is to get his hands on the BoE's gold reserves illustrated by the gold coins in her pocket and the money-chest on which she is firmly sat. It was privately owned by stockholders from its foundation in 1694 until it was nationalised in 1946 by the Labour Government who were elected directly at the end of the second world war. The main building is not open to the public for obvious security reasons given the amount of gold held under lock and key!

Changing role

In 1781 the BoE became the bankers' bank and was required to keep enough gold in reserves to pay all its issued notes on demand, a promise still printed on every bank note today. Its primary functions today are to maintain monetary stability, through the independent setting of interest rates, oversee financial stability of the UK financial system and act as the lender of last resort. This was memorably demonstrated during the financial crisis when on Wednesday 12 September 2007 Northern Rock sought and received a liquidity support facility from the BoE as it was hit severely by the credit crunch, which was triggered by sub-prime mortgages turning sour. Two days later, on hearing the news of support, customers of the bank queued for hours to withdraw their savings, resulting in over £1 billion in just one day of withdrawals and eventually it had to be nationalised. Both the Royal Bank of Scotland and Lloyds Bank were partially nationalised soon after to avoid the whole financial system failing. In addition, the BoE is responsible for controlling the UK's gold reserves and issuing bank notes in England and Wales.

Monetary Policy Committee (MPC)

When Tony Blair became Prime Minister in 1997 his then Chancellor of the Exchequer, Gordon Brown, announced that the BoE would be granted operational independence over the setting of monetary policy. Under the terms of the Bank of England Act 1998 the Bank's Monetary Policy Committee (MPC) was given sole responsibility for setting interest rates to meet the UK Government's inflation target, which at the time was 2.5%. Later in December 2003, the inflation target was changed from the Retail Prices Index (RPI) to track the Consumer Prices Index (CPI) target of 2% to bring the UK in line with the European Union.

The MPC is made up of nine members – the Governor, the three Deputy Governors for Monetary Policy, Financial Stability and Markets and Banking, the BoE's Chief Economist and four external members appointed directly by the Chancellor of the Exchequer. External members are appointed to make sure that the MPC benefits from thinking and expertise from outside of the BoE. A representative from HM Treasury also sits with the MPC at its meetings. The Treasury representative can discuss policy issues but is not allowed to vote. They are there to make sure that the MPC is fully briefed on fiscal policy developments and other aspects of the UK Government's economic policies, and that the Chancellor is kept fully informed about monetary policy.

Quantitative Easing (QE)

Central banks around the world have played an increasingly important role in providing financial stability. Initially during the financial crash in 2008 nationalising certain banks and financial institutions, and then embarking on a programme of Quantitative Easing (QE). Since the start of the pandemic central banks have supported liquidity in the financial markets and extended QE further. The best description of this process is actually posted on the BoE's own website which reads – 'Here's how QE works: We (BoE) buy UK Government bonds or corporate bonds from other financial companies and pension funds. When we do this, the price of these bonds tend to increase which means that the bond yield, or 'interest rate' that holders of these bonds get, goes down. The lower interest rate on UK Government and corporate bonds then feeds through to lower interest rates on loans for households and businesses. That helps to boost spending in the economy and keep inflation at target. QE also effects the prices of other assets like shares and property. Here's an example. Say we buy £1 million of government bonds from a pension fund. In place of those bonds, the pension fund now has £1 million in cash. Rather than hold on to that cash, it will normally invest it in other financial assets, such as shares, that give it a higher return. In turn, that tends to push up on the value of shares, making households and businesses holding those shares wealthier. That makes them likely to spend more, boosting economic activity.'

Communication

Finally, one overriding role of a central bank is the way the institution communicates with the financial markets and the public. Mark Carney was the first non-Briton to be appointed to the role of Governor in 2012 since the BoE was established (he was replaced by the current Governor, Andrew Bailey in 2020). Mr Carney launched its 'forward guidance' policy in August 2013 with the intention of making monetary policy more open and transparent – namely by well publicising unemployment figures so that they could be used to provide significant and tangible evidence of whether macro-economic policy was working in general, and whether, specifically, monetary conditions will be tightened or loosened as a result. The change was designed to build a better working relationship between the BoE and the financial markets allowing markets to anticipate bank interest rate changes or whether other support measures like QE were going to be reduced or tapered. This was initially welcomed but when unemployment fell below the target of 7% and no action was taken to increase interest rates, the BoE tried to explain that this was 'threshold' and not a 'trigger' for action. Unfortunately, this was enough for financial markets to question the validity of the decisions being taken based on the data being released. Although this clearly wasn't helpful in creating the trust levels desired, the discussions held by the MPC, the votes taken by its members, the decisions they take and the words they used to update markets are increasingly scrutinised.

The decisions they take affect all of us, especially borrowers, savers, and investors. The price of different assets and their perceived value can be heavily swayed by the announcements they make and the way they are interpreted. Investment markets do not like surprises, so if the latest decisions are not in line with expectations it can have a dramatic effect on share prices or bond yields which are reassessed by investors if interest rates or financial support, like QE, are going to change sooner, further and faster than expected. The latest communication from the BoE has indicated that inflation has risen further than initially expected meaning they will probably increase the base rate earlier than thought. Central Banks, both here in the UK and abroad, play a pivotal role in attempting to maintain certainty in an uncertain world.

Find out more!

Click **here** to read our latest A Month in the Markets, where our Head of Multi-Asset Solutions Stefano Amato looks at how key themes impacted markets in September.

Note: Data as at 12 October 2021.

Important Information