PICTURE THIS

The Three-Hundred-Year Low

The Bank of England's policy rate is the lowest ever

NEVER—in more than three hundred years of combating the effects of investment bubbles, global depressions, and world wars—has the venerable Bank of England (BoE) lent money this cheaply. The current global recession has accomplished what no previous business cycle since the start of the Industrial Revolution ever achieved: it has led the U.K. central bank to lower its base rate to virtually zero. What's more, the Old Lady of Threadneedle Street (the BoE's affectionate sobriquet) has decided to move beyond interest rate cuts, adopting unconventional policies to try to restart the U.K. economy.

When the effects of the global financial crisis that began in the United States started hitting the U.K. economy in 2008, the BoE first reacted with the tried and trusted strategy of reducing official interest rates to make loans cheaper and thus keep companies and individuals borrowing and spending. The central bank cut its official bank rate, the rate of interest at which it lends to banks, from 5.5 percent at the start of 2008 to 2 percent at year-end.

As the chart shows, the five cuts in 2008 alone dropped the BoE's bank rate to record-equaling lows last seen during banking crises in the 1880s and 1890s, and after the Great Depression and World War II in the 1930s and 1940s. Yet even an interest rate of 2 percent was not judged low enough this time to restart the economy and prevent inflation from undershooting the official target.

Leading indicators of economic activity continued to plunge, amid falling stock prices and bad news from the country's banking system. So the BoE cut the bank rate to 0.5 percent by early March 2009. And it reached for Plan B: if no one else was going to buy in this depressed environment, the Old Lady would. In a move that continues to test the boundaries of conventional central banking, the BoE started buying financial assets, primarily government bonds, in March 2009.


Founding of Bank of England by royal charter in 1694.

As good as gold

Among the key central bank functions assigned to the BoE in the 19th century was that of monopoly issuer of bank notes, which began with the Bank Charter Act of 1844. The Act also set the stage for almost a century of the gold standard by stipulating that BoE bank notes had to be backed by gold.

The BoE assumed a further central banking role in the mid- to late 1800s by becoming lender of last resort during a succession of domestic banking crises. As expanding local and international commerce led to the formation of large clearing banks, the BoE stood behind the retail banking system as a supplier—and controller—of liquidity.


Gold bullion from California delivered to Bank of England in 1849.

England goes Dutch

England's Glorious Revolution of 1688 heralded the establishment of the Bank of England. When King James II was dethroned and his son-in-law William of Orange installed as monarch, among the ideas imported from William's native Holland was that of a national bank. After several false starts, the English parliament approved a proposal by London-based Scottish entrepreneur William Paterson for a Bank of England, and the BoE was founded by royal charter in 1694.

At first, the BoE was solely the government's banker and debt manager, as the state's demands for financing escalated in step with military campaigns culminating in the Napoleonic Wars two centuries ago. The concepts of a national debt created by government borrowing, and of credit creation as the definition of money moved beyond cash, also crystallized during the BoE's 18th century operations.

Sources: Bank of England; and www.bankofengland.co.uk

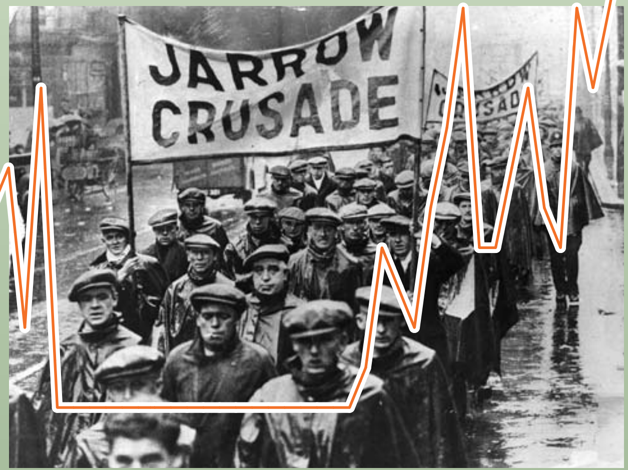

U.K. forces march into Cambrai, France, during World War I.

Open that war chest

The vast expenses of warfare were always going to test the discipline of basing money on gold and, despite a hike in the bank rate to 10 percent, World War I proved the undoing of the U.K.'s gold standard. After the link to gold was finally abandoned in 1931, parliament could order expansion of the money supply to fight the unfolding economic crisis.

The official bank rate was cut to its prior historic low of 2 percent after the Great Depression, and rates stayed at 2 percent during World War II. The combination of low interest rates and military spending helped the U.K. economy recover from the 20th century's worldwide depression.

It was a short step from abandoning gold to nationalizing the BoE altogether, which was accomplished after World War II in 1946. The government could now appoint the central bank's governor, and used the BoE to administer exchange and credit controls in the United Kingdom's austere postwar economy.



March in 1936 protests high U.K. unemployment.

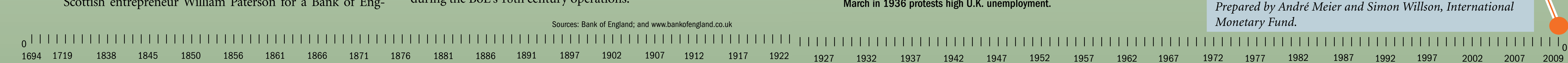
Era of volatility

The rising volatility in bank rate shown on the right of the chart started in the 1960s, when growing balance of payments deficits triggered pressure on the pound sterling's fixed exchange rate and led to a destabilizing devaluation in 1967. After sterling floated in 1973, a combination of oil price shocks and loose macroeconomic policies led to soaring U.K. inflation and a subsequent hike in the base rate to a record 17 percent in 1979.

The BoE was successful in bringing inflation down to safer levels in the 1980s. Its capacity to keep future inflationary pressures in check was further strengthened when the BoE was granted full operational independence for monetary policy in 1997. Freed from political influence and equipped with a clear mandate for price stability, the BoE has managed to keep inflation on target over the past decade. Its credibility has also allowed the BoE to move aggressively in easing monetary policy in recent months as the financial crisis unfolded.


Old-style one-pound notes, since replaced by coins.

BoE has kept inflation on target over the past decade.



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