

Treasury Committee

Questionnaire for Mervyn King

For reply by Wednesday 23 April at 10.30 am

Management and governance

1. What reforms of the Bank of England have you instituted during your first term as Governor and what has been the purpose of those reforms?

When I became Governor, I submitted to the Court of the Bank a paper entitled "The Bank of England: the next five years". Its first paragraph read:

"My vision for the Bank is that it should be focussed on promoting monetary and financial stability in the United Kingdom. It should play an active role in the international monetary and financial community. But it should not take on additional responsibilities which are outside the remit of the 1998 Act and Memorandum of Understanding. Its work should be seen as a hallmark of excellence". I went on to say that, "there are three main challenges that will confront the Bank over the next five years. First, keeping inflation on track to meet the target during a period of re-balancing of the UK economy. Second, focussing the work of the Financial Stability area of the Bank in order to make it more operational. Third, building a culture of even greater professionalism in the Central Services areas of the Bank".

Given those objectives, we initiated a fundamental review of the Bank's strategy. As a result, a number of significant reforms were made to the way the Bank works. The core purposes of the Bank were reduced from three to two, covering the promotion of both monetary and financial stability. And to implement the strategy, one of my first steps as Governor was to reform the internal management of the Bank, creating a single Executive Team.

On the monetary stability side, we have managed to keep inflation on track to meet the target, notwithstanding the large external shocks of the past year or so. Since 1997, the target rate of inflation has averaged within 0.1 percentage points of the target itself. Although the arrangements for analytical support of the MPC have remained largely as they were, significant reforms were made to the Bank's money market operations. The objectives of those reforms were to keep overnight interest rates in money markets as close to Bank Rate as possible, in an efficient, simple and flexible way. The changes have transformed our ability to implement monetary policy on a day-to-day basis. I am also pleased to have had the new system in place ahead of the recent financial turmoil. Banks have been able to increase the reserves they hold with us because they are able to alter their target levels of reserves once a month. And these balances have increased by 42% since the start of last August.

On the financial stability side, we instituted a re-organisation of the Bank's Financial Stability area. The objective was to make the area more operational. Its

work is now focussed on four issues: risk assessment; risk reduction; the oversight of payments systems, and crisis management. To supplement that, the Bank has created a market intelligence function. We have since 2004 built a large network of contacts in global financial markets, which has been a valuable source of intelligence, especially during the current financial turmoil. We have also launched a new-style Financial Stability Report to sharpen our communication of the key risks to financial stability.

A new Memorandum of Understanding between HMT, FSA and the Bank was agreed in 2006. The revised Memorandum replaced the statement that the Bank was “responsible for the overall stability of the financial system” by a description of the four ways in which the Bank contributes to financial stability: by ensuring the stability of the monetary system; by overseeing those parts of the financial system’s infrastructure that may affect the stability of the UK financial system; by maintaining a broad overview of the UK financial system as a whole; and by undertaking, in exceptional circumstances, official financing operations. The main reason for the change was the mismatch between the responsibilities attributed to the Bank and the powers (or lack of them) given to the Bank to enable it to discharge those responsibilities. We will need to consider the case for further revisions in the light of the outcome of the consultation process on banking legislation which is underway and on which the Treasury Committee has expressed its views.

In the Central Services parts of the Bank, we have continued to reduce costs while enhancing the quality of the service provided by making external appointments to the positions of Finance Director, HR Director and Head of the Legal Unit.

All of these changes to the Bank were designed to ensure that we could meet our objectives. At the same time, a key feature of the strategy has been to ensure that everything we do flows from our two core purposes of promoting monetary and financial stability. The Bank has, for example, withdrawn from banking activities that do not contribute to them.

This greater focus has allowed us to improve our ability to pursue the two core purposes and, at the same time, keep spending on our policy functions broadly constant in money terms. The Government has been able to propose a reduction in the proportion of deposits that banks have to hold with the Bank as Cash Ratio Deposits from 0.15% of eligible assets to 0.11%.

2. What do you regard as the main challenges you will face as Governor of the Bank of England during the next five years?

The Bank is likely to face major challenges in relation to both monetary and financial stability.

The Monetary Policy Committee faces the challenge of keeping inflation close to the 2% target. That is unlikely to be straightforward. When I became Governor in 2003, I referred to our economic performance over the previous ten years as the *nice* (non-inflationary, consistently expansionary) decade. But in the past two

years we have seen that changes in the rest of the world – such as a sharp rise in oil and other energy prices - can push inflation materially away from the target. The MPC will need to ensure that these deviations are temporary so that they have minimal impact on the expectations of those setting pay and prices. This will not be the last time it faces a balancing act between avoiding unnecessary volatility in economic activity and avoiding any tendency for deviations of inflation from the target to persist.

In the area of financial stability, the immediate challenge will be to ensure that the necessary adjustment in the financial sector does not result in a loss of confidence in financial markets and the banking system. The financial sector is reducing the size of balance sheets by cutting back on lending and raising new capital. That is not a process we can, or should try to, stop. By ensuring that banks can access liquidity, the new Special Liquidity Scheme will support confidence during this period of adjustment.

The second challenge in the area of financial stability will be to embed in our institutional structure the lessons from the recent financial turmoil. We are reviewing our framework for market operations. In addition, the Government will decide, in the light of the response to the Consultation Document published in January and the Treasury Committee's own Report, what responsibilities the Bank will have in this area. I am determined that the Bank should accept new obligations only if it is granted sufficient powers to meet them.

3. How do you think the Court of the Bank of England has operated during your first term and how do you expect its role to change during your second term?

Court's role, as set out in the 1998 Act, is to "manage the Bank's affairs, other than the formulation of monetary policy" and to "ensure the effective discharge of the Bank's functions." When I became Governor, Court meetings were restructured to focus on the management of the Bank and, as far as possible given the constraints of the 1998 Act, have been conducted in the Committee of non-executive directors under the chairmanship of the senior non-executive director. The objective was to make Court's discussions more focussed and to introduce effective challenge by non-executive directors.

In my view Court has fulfilled its role very effectively. It supported the implementation of my 2003 strategy by translating it into a concrete business plan with clear priorities and by holding the executive to account for delivery of them. Through its oversight of the Bank's budget, Court has ensured value for money. And it has helped resolve difficult management challenges. To give one example, Court played a key role in the review of the Bank's pension scheme. It defined both an upper limit for the share of the pay bill spent on pensions and the timeframe over which the Bank had to meet that target. Between 2006 and 2007, Court discussed the issue six times and the Bank introduced a new pension scheme for new entrants in October 2007.

Looking forward, the government intends to amend the provisions governing the

size and composition of Court. Its proposals in this area are, I believe, sensible.

In the recent consultation document, the government stressed the role of Court in overseeing the Bank's work in financial stability. Court already has this responsibility and agreed last December to a revised framework for its oversight of the Bank's work in this area. At its most recent meeting, Court agreed to review that framework once the questions about the Bank's future role in financial stability have been resolved. That is an entirely sensible conclusion. Of course, we need to avoid potential conflicts of interest.

Interest rate decisions and economic policy

4. How have you worked to combat the uncertainty around the economic outlook over recent times?

Uncertainty about the outlook is a natural feature of the economic landscape. It is important for the MPC to be open about the fact that we do not know precisely how the economy will evolve. Our aim is not to add to that uncertainty by setting interest rates in an unsystematic way. In times of heightened uncertainty, it is important that people can have confidence in what the MPC is doing and that, although inflation may move away from the 2% target temporarily, we will return inflation to the target.

Setting Bank Rate to meet the inflation target is not straightforward when the outlook is so uncertain. The job of the MPC is to focus on the full range of evidence available to us. As well as the official data and surveys from business organisations, that includes reports from our Agents around the country, who talk to their 8000 business contacts, the surveys which the Bank conducts on its own account, including the recently launched Credit Conditions Survey, and the information we pick up from our own visits around the country.

It is crucial that we do not have a fixed plan for Bank Rate but that we are prepared each month to respond as the data unfold. We need to explain clearly the actions we take and what we are trying to achieve. There are many ways in which we are held accountable. This will be my fifth appearance before the Treasury Committee since the onset of the financial turmoil. I have held two Inflation Report press conferences, delivered two major speeches – in Belfast and Bristol – and given many 'off-the-record' talks, both in and outside London, including to business groups, trade associations, Members of Parliament and students. On these occasions, I try to explain two things: the nature of the economic challenges we face, and what the Monetary Policy Committee is aiming to achieve when it sets Bank Rate. Every member of the Monetary Policy Committee has a similar speaking programme.

As I set out in my speech in Bristol, the MPC faces a difficult balancing act at present. We must balance the risk of a sharp slowing in activity this year, which would pull inflation below target next year, against the risk that without some slowing in the pace of activity, above-target inflation in the short term might have some tendency to persist.

5. To what extent do you think that the current turmoil in financial markets will affect business investment?

There are three ways in which the financial turmoil is likely to affect business investment. First, uncertainty about the prospects for demand growth is likely to lead companies to postpone investment projects. The Bank's Regional Agents reported in April that investment intentions had fallen across most industries and that much of that stemmed from uncertainty about the impact of financial market events.

Second, the closure of markets in asset-backed securities has left the banking system with an overhang of assets on its balance sheet. Banks have responded to this overhang by seeking to cut back the growth rate of new lending to both companies and households. The Bank's most recent survey of credit conditions showed that lenders had tightened the supply of credit to companies in the first three months of the year and that they expected this tightening to continue.

The third channel through which the financial turmoil will affect business investment is through commercial property prices. Around one third of business investment spending is on buildings and has been supported by strong demand for commercial property – evident in rising prices. But since June, demand for commercial property has eased and prices have fallen by over 10%, reducing the incentive to invest.

These developments are likely to bear down on investment spending, although our central projection is for the growth rate of business investment to slow only a little more sharply than overall economic activity in the near term before recovering a little in 2009. This is because a number of factors continue to support investment. There still seems to be fairly solid growth in the economy outside the energy-related sectors. The net rate of return on capital employed in the private non-financial sector is high. And many companies will be able to use retained earnings, rather than borrowing from banks, to finance new investment.

6. When considering the UK economy, how much emphasis do you place on the international economic environment? How concerned are you about global imbalances?

Developments in the world economy can be crucial for the outlook for an open economy like that of the United Kingdom. So I – like all MPC members – place great weight on assessing developments in the world economy. But we cannot simply assume that fluctuations in world activity will go hand in hand with fluctuations in output at home. In 2005, strong growth in the world economy was one factor behind the *slowdown* in the United Kingdom. Rapid expansion of the world economy pushed up commodity and energy prices, which slowed the growth of real incomes and hence consumer spending.

The credit crunch has, as I explained in my speech in Belfast last October, its origins in the imbalances that had built up in the world economy. What Ben Bernanke, Chairman of the US Federal Reserve, has described as a 'glut' of savings, first from Asia, and more recently from oil-producing nations, has driven

down real interest rates in world capital markets. Those low interest rates have, in the West, encouraged borrowing and generated large trade deficits. They also encouraged some investors, who were slow to adjust to the new reality of lower returns, to embark on a 'search for yield' by purchasing risky assets without stopping to question whether the assets were too expensive.

The re-pricing of risk to a more sustainable level that is now underway is likely to be accompanied by some unwinding of global imbalances. In the UK, our national saving rate is likely to rise. But the imbalances are unlikely to unwind fully as long as the supply of savings to world capital markets remains strong. The difficulties evident in the current, partial, adjustment should make us all concerned about how the imbalances will eventually unwind. If the 'glut' of savings on world capital markets were to be withdrawn abruptly as the Asian and oil-producing economies spend more of their incomes, we could see further sharp movements in asset prices and real exchange rates. So I remain concerned about global imbalances.

7. To what extent do you think that consumers have been affected by the recent disturbances in financial markets?

The disturbances in financial markets and associated overhang of assets on banks' balance sheets have led to a tightening in the supply of credit from the banking system to households. The Bank's Credit Conditions Survey showed that lenders have been tightening conditions, particularly for secured lending, and intend to do so further. The most significant impact has, to date, been on the housing market, where the tightening of credit conditions has affected those renewing or taking out new mortgages.

The tightening in conditions for new borrowers is likely to generate a fall in the ratio of house prices to earnings over the next few years. Indeed, over the first three months of this year, the major lenders reported that house prices fell. That will have some impact on consumer borrowing and saving, which coupled with only weak growth of real take-home pay as energy and food prices rise, will slow the growth rate of consumer spending this year, possibly quite sharply.

There is some tentative evidence that consumers have already reacted to these developments. In the final quarter of 2007, the growth rate of consumer spending, particularly on durable goods, did slow. Measures of consumer confidence have fallen sharply this year. And surveys suggest that retail spending has slowed, although not yet as far as it did in 2005. Official retail sales data, however, showed surprisingly strong growth in the first quarter. It is too soon to conclude that the disturbances in financial markets have had a clear impact on consumers. But I expect to see some slowing in the official reports of consumer spending over the coming months.

Financial Stability

8. In your first term of office, what reforms have you undertaken to the Financial Stability section of the Bank of England and what has been the purpose of those reforms?

See my response to question 1.

9. In view of the proposals in Chapter 6 of *Financial stability and depositor protection: strengthening the framework*, how do you see the work of the Bank of England in the area of financial stability developing during your second term?

The answer to this question will depend on decisions by Government. The Bank's financial stability work is likely to change most if it is given responsibility for the new special resolution regime for banks, along the lines, for example, of the proposals of the Treasury Committee. Once the Government has made its decisions, the Bank will make the necessary changes to its financial stability function to discharge whatever responsibilities it is given. But whatever model is adopted we will make a number of changes. I would highlight four.

First, a lesson from Northern Rock is that the Bank needs to be directly involved with a bank for which a support operation may be necessary prior to giving that support. That points to adopting a model of graduated Bank involvement. In periods of calm, when financial stability risks are low, the FSA would be responsible for prudential discussions with banks. In periods of heightened stress the Bank would join the FSA in engaging with vulnerable banks. Finally, in periods of severe stress, in which support had been, or was about to be, provided, the Bank of England would take the lead with the bank(s) in question.

Second, we need to strengthen the connection between system-wide risk analysis and the outlook for individual banks. And we need to communicate our analysis of the risks more sharply. It is no good identifying the right risks if no one responds to that analysis.

Third, the Bank will need to adapt its crisis management planning to take account of the new resolution regime. This will be necessary regardless of which body is given responsibility for implementing the regime.

Fourth, I intend the Bank to contribute to the design of regulatory and incentive structures for the financial system, to try to curb the excessive build-up of risk-taking and credit creation which was seen ahead of the recent crisis.

10. Do you foresee the Financial Stability section of the Bank of England requiring additional resources to undertake its work, bearing in mind the likely additional responsibilities and the more unsettled nature of international financial markets?

We have reallocated existing resources within the Bank to cope with the present financial turmoil. But it is too soon to speculate about the resources that will be required in the longer term until the Bank's responsibilities are agreed.

11. What personal role will you undertake with regard to the work to be conducted in the Financial Stability area?

As Governor, I represent the Bank in discussions between the tripartite principals. Under the Memorandum of Understanding I have responsibility for advising the Chancellor about the case for exceptional support operations. Internationally I represent the Bank at the bi-monthly meetings of central bank governors in Basel, which often discuss cross-border financial stability issues, and along with the Chancellor, I represent the UK at G-7, G-20 and IMFC discussions. I also have regular meetings with representatives from the private sector.

Within the Bank, I am a member of the Bank's Financial Stability Board. Through that, I will contribute directly to strengthening our analysis of the implications for individual banks of system-wide risks. And together with my colleagues I will sharpen the communication of our financial stability messages. In June, I will be speaking at the British Bankers Association annual banking conference on financial stability issues. I intend to keep under review the case for further speeches on this topic in light of market conditions and changes to the structure of financial stability oversight in the UK.

Bank notes

12. What do you see as the priorities for the Bank of England in relation to note issuance during your next term?

I have two objectives for our note issuance work: to maintain confidence in the integrity of Bank of England notes; and to ensure that people can at all times obtain the notes they want.

Anti-counterfeiting measures are crucial if we are to maintain confidence in our notes, so my first priority is to ensure that our notes contain the most effective security features. Our new £20 note contains many new security features. Since its introduction, the total value of counterfeit notes discovered has fallen by around a quarter. We will introduce further anti-counterfeiting measures as necessary. The London Olympics also present a challenge. We need to ensure that they do not become an opportunity for counterfeiters to exploit the large influx of visitors who are unfamiliar with our notes. We are working closely with the police and the Serious Organised Crime Agency to combat all attempts to counterfeit our notes.

To allow people can get the good-quality notes they want, the Bank is focussed on ensuring efficient and robust processes for the distribution of cash. My priority in

this area is to get more £5 notes into circulation. I raised this issue in my speech in June 2007 at the Mansion House. Since then, the value of £5 notes in circulation has risen by 15%. We have written to the cash distribution industry setting out the Bank's objective and seeking agreement on ways in which that objective can be achieved. I want to see progress this year.

There are two other areas in which the Bank is working. First, following the robbery at the Loomis cash centre at Tonbridge in early 2006, the Bank has orchestrated an extensive programme of work to make sure that the network of private cash centres across the country has robust defences. Improvements to security have been made, but there is more to do.

Second, the Banking Reform Consultation document proposes reform to the arrangements for protecting holders of notes issued by banks in Scotland and Northern Ireland. These proposals are not intended to end the practice of banks issuing notes, but to ensure that their notes are covered at all times with risk free assets and, in doing to, to ensure that holders of these notes are themselves fully protected.

Market operations

13. What principles should underpin further reforms of the Bank of England's money market operations in the light of recent events?

As I told the Treasury Committee in December, the Bank is now reviewing its money market operations. In due course we shall publish a revised 'Red Book', which describes our system. I believe that three key principles should underpin any reforms:

First, the primary objective of our market operations is to implement monetary policy by keeping interest rates on overnight borrowing in the money markets in line with Bank Rate set by the MPC. Our framework must deliver this in normal and stressed conditions alike.

Second, as I explained to the Treasury Committee in my note of 12th September, there are circumstances in which it is necessary for banks to be able to access funding from the central bank to prevent a major shock to the financial system as a whole. But any such funding requires a balancing act. Although it can remove fragility in the financial system, it can also encourage excessive risk-taking in the future.

Third, central bank operations tackle issues of liquidity. They do not tackle issues of solvency. They should not insulate banks from the risk of losses on the loans they have made and the risk to the public sector from these operations should be minimised.

The Special Liquidity Scheme, launched on Monday 21 April, is a temporary measure designed to deal with the current problems. It does, however, embody these principles and in reforms to our market operations, we will build on the lessons we learn from the Scheme.

International role

14. During your next term in office, what are your priorities for your work within the IMF?

I have spent considerable time during my first term pressing the case for reform of the IMF. I am delighted that the IMF has started to reform itself along the lines I have been proposing. The first challenge in my next term will be to encourage the IMF to convert the announced reforms into changes in actual working practices.

At the IMF spring meetings in April, a package of reforms to voting rights, shifting voting power towards fast-growing economies, was endorsed by the Fund's Governors. These changes are welcome but more substantial reform along these lines will be needed if the IMF is to command widespread support amongst its membership. I intend to make that case with my international colleagues.

The current financial turmoil has highlighted just how important it is that IMF surveillance is focussed on spillover effects between countries. Its analysis should highlight the consequences of governments' policies, not just for their own economic stability, but for the stability of others. My objective is to ensure that this focus is delivered in the statement of priorities for surveillance, which will be agreed by September between staff and shareholders.

I said in my answer to question 6 that I remain concerned about global imbalances. IMF analysis has a major role to play in explaining dispassionately to national authorities the impact of their decisions on the world economy generally. I will work with other central bank governors and finance ministries, through all international groupings, to respond to the IMF's analysis and seek to resolve the global imbalances in an orderly manner.