BANK OF ENGLAND

REPORT AND ACCOUNTS 1998

CONTENTS

Eddie George, Governor.

GOVERNOR'S FOREWORD

THE past year has been a momentous one for the Bank of England. The Government announced shortly after taking office that it had decided to give the Bank operational independence in the conduct of monetary policy. A fortnight later, the Government announced a radical reform of the entire structure of financial services regulation, including the transfer of the Bank's responsibility for banking supervision to a new regulatory body for the financial services industry as a whole, the Financial Services Authority (FSA). The Bank will, nevertheless, continue its traditional responsibility for maintaining the stability of the financial system as a whole.

The new Bank of England Act, which will formally introduce these changes, will come into force on 1 June. It does not fundamentally alter the Bank's raison d'être as the central bank of the United Kingdom, the heart of which remains the maintenance of monetary and financial stability, and the promotion of the effectiveness and efficiency of the financial system. These are the three core purposes, which the Bank formally adopted in 1992 to guide its strategy. But, the changes do bring greater clarity to our responsibilities, and will contribute to increasing the transparency and public accountability of the Bank's activities.

The overriding purpose of the new monetary policy arrangements is to improve the credibility of policy, and to demonstrate the Government's commitment to achieving and maintaining effective price stability. The new Bank of England Act states that the objectives of the Bank shall be to maintain price stability and, subject to that, to support the Government's economic policy, including its objectives for growth and employment. This makes it clear that price stability is not an end in itself; rather, the ultimate objective of economic policy is the growth of output and employment and thus rising living standards. The intention behind seeking permanently low inflation, is to break away from the boom-bust cycles of the post-war years, which led to a persistent ratcheting up of inflationary expectations and a steady erosion of long-term thinking and planning, saving and productive investment, on the part of consumers and businesses. By seeking price stability, we can realistically hope to moderate those cyclical swings in output and prices, helping to sustain growth into the medium and longer term, and thereby hopefully adding to the productive potential of the economy.

I welcome the procedures that the Government has introduced, formally through the new Bank of England Act, to govern the operation of monetary policy, and particularly the establishment of the Monetary Policy Committee (MPC) at the Bank. Under these arrangements, the Government is responsible for setting the inflation target, while the MPC is responsible for implementing that target. The MPC will, when fully constituted after the Act comes into force, have nine members, five of whom will have executive responsibilities within the Bank, while the remaining four will be appointed from outside by the Chancellor. The Act provides that those outside appointees must have knowledge or experience which is likely to be relevant to the MPC's function of formulating monetary policy. This means that not only will they be experts in their field, but they will also bring a broader base of expertise to our decisions. The first four appointments to the MPC by the Chancellor, in my view, admirably demonstrate that infusion of expertise.

The past relationship, in which the Bank advised the Government on monetary policy, involved a measure of advocacy. The MPC process, on the other hand, involves open debate within the Committee based upon a regular and systematic assessment of all the economic and financial information that the Bank can muster. Moreover, the new arrangements provide for a greater degree of transparency and public accountability on monetary policy than anywhere else in the world. This comes through the publication of the minutes of MPC meetings and the quarterly *Inflation Report*, both of which are established formally in the new Act. It involves potentially, too, the publication of an open letter to the Chancellor if inflation strays by more than 1per cent in either direction from the target.

Much has been made of the fact that after more than six months in which the members of the MPC found it relatively easy to agree on monetary policy, a disagreement emerged in January which then persisted. The fact that the Committee should have been divided over the precise stance of policy should not have been a surprise. It is naturally easier to agree in circumstances when policy is clearly inconsistent with the target; but when policy is broadly on track, differences about marginal changes to the stance of policy are more likely to emerge, even though all members of the Committee are guided by the same objective set by the Government. This reflects the reality that the conduct of monetary policy is not a precise science; but it reflects also that members of the MPC, quite rightly, reach their decisions in an individual capacity.

Turning to the substance of monetary policy, the past year was the sixth in succession in which the Bank's financial year, to the end of February, saw a combination of relatively low inflation, relatively steady growth, and falling unemployment. But, there is little doubt that over the past year the going, in terms of maintaining this performance, has become tougher. During the year domestic demand, and especially consumer spending, picked up to a rate that could not be sustained for long without inflationary pressures re-emerging. Although it is hard to measure in an exact way, much of the spare capacity in the economy had undoubtedly been used up. It was against this background that the MPC needed to tighten policy last summer.

That situation has, however, been complicated by the strength of the sterling exchange rate. Sterling's strength, in particular against the major European currencies, has created a dilemma for monetary policy which has been with us in varying degrees since the second half of 1996. Some part of the strength of sterling has certainly been a reflection of relative interest rates in Britain and Continental Europe, which in turn reflects our differing cyclical positions, as the Continental economies have only recently emerged from a long period of downturn in their cycle. But the strength of sterling cannot be wholly explained in this way. It probably also had something to do with the process of putting together European Monetary Union. One contributory factor may well have been the immense and praiseworthy efforts to meet the Maastricht budget deficit criterion, which affected the mix between fiscal and monetary policy on the Continent. Sterling's strength has also been ascribed by the markets to nervousness that a broader membership of EMU will lead to a weak euro, because - it is said - the European Central Bank will somehow be more likely to be subject to political pressures. I believe that the prognosis of a weak euro is wrong. I expect the determination of the European Central Bank to establish the euro as a sound and credible currency to be increasingly demonstrated as the project moves ahead.

In these circumstances, the tightening of monetary policy in this country last year, which was necessary in order to moderate the growth of domestic demand, put further upward pressure on the exchange rate at a time when the internationally exposed sectors of the economy were already taking a battering from the strength of sterling, a battering which was then compounded by the economic effects of the financial crises in Asia. But, while the nature of the dilemma created by the exchange rate is clear, there is nothing to be gained from sacrificing the objective of long-term price stability, and, through that, growth and rising living standards. To do that would expose the whole economy to the destructive effects of inflation, including those sectors which most wish to be protected from the immediate damage caused by the strength of sterling.

The Chancellor announced in October 1997 that the UK would exercise its opt-out and not participate in the first wave of membership of European Monetary Union. This was a cause of regret for some, both in this country and among our European partners. But it was a considerable relief to others, because UK participation from the outset would have complicated the launch of EMU, not least because of the sustained cyclical divergence that continues to exist between the UK and the major countries on the Continent.

But the Chancellor made it clear that the Government is not opposed to membership of Monetary Union as a matter of principle. Rather, it will make its decision on pragmatic, economic grounds, and submit that decision to Parliament and to the British people in a referendum. Barring some unforeseen circumstances, the Chancellor recognised that it was unrealistic to think that a decision could be made during the lifetime of the present Parliament. The Chancellor emphasised, however, that in the meantime the UK should prepare, both for the introduction of the euro in other countries on 1 January 1999, and for our own eventual participation.

This was the first statement by a British Government to declare for the principle of monetary union. It implied that the UK is to be regarded effectively as a 'Pre-In'. It recognised that the single currency will affect us, whether we are in or out of it, and that it is clearly in our national interest to play a full part in ensuring that the euro is successful. This provides a solid foundation for a continuing, positive and constructive relationship between the UK and the initial members of EMU. Such a constructive relationship is in the interests of both sides; just as we will benefit from a stable and prosperous Europe, so too the participating countries will benefit from a stable and prosperous Britain.

There are important things that we can do to help ensure that the launch of the euro is a success. First, the UK can help by maintaining its commitment to macro-economic discipline, both fiscal and monetary, a commitment which it shares with the initial member countries. Beyond that, the Government is committed to pursuing itself, and advocating in the Councils of Europe, policies aimed at increasing the supply-side flexibility through structural reforms designed to improve the efficiency of labour, product and financial markets. The European Monetary Institute's Convergence Report, issued in March 1998, made clear the need for countries, including both the initial members and those envisaging joining at a later stage, to continue to pursue policies directed towards macro-economic stability and supply-side flexibility. These policies make sense, not only as a matter of national economic self-interest, but also because they will make the UK a more prosperous and active trading partner for Europe as a whole, and thereby ensure that we do not have any avoidable disruptive impact on the policies or on the economies of the participants in monetary union. Beyond this, too, they are calculated to foster sustainable economic convergence as the necessary precursor to our eventual membership of the euro club.

The second area in which the UK can contribute to the launch of monetary union is by playing our part in developing a sound and efficient infrastructure for euro-denominated financial markets. The potential benefits of the euro derive importantly from the exchange rate certainty which it will provide across the euro area. But they will derive, too, from the greater transparency and liquidity of unified wholesale financial markets in the euro-denominated instruments rather than the fragmented markets denominated in the various national currencies that we have now. The City of London has a proven track record of providing transparent, liquid, competitive, innovative and well-regulated financial markets denominated in many currencies, and the Bank is fully committed to ensuring that the preparations are made to provide the same market environment for the euro. Like trade in goods, trade in financial services is a positive sum game, so that London's success is not a threat to other European financial centres. There will be a vigorous Euro-euro market in London, just as there are vigorous markets in Euro-Deutsche Mark, Euro-francs and Euro-dollars and so on now, and this will contribute to the development of the euro as a widely-used international trading and investment currency.

Throughout the past year, the Bank has continued to play an active role in assisting the City, and the financial sector more generally, with preparing for the euro. We have done this through continuing to publish the quarterly *Practical Issues Arising from the Introduction of the Euro*, holding seminars, undertaking roadshows in other major financial centres around the world, and through a very wide range of contacts with individual firms, exchanges, and trade associations. This work will continue throughout the coming year, as we move through the launch of the euro, and beyond. Preparing for the euro is a substantial undertaking, but I have no doubt that the City of London will be ready to trade in the whole range of euro wholesale financial products from the beginning of 1999.

The Government's plan to reform the regulation of financial services is a bold and radical step. The FSA will become responsible for the regulation of effectively all forms of financial intermediation. The new allocation of responsibilities for regulation and financial stability in the UK was formalised last autumn in a Memorandum of Understanding between the Bank, the FSA and the Treasury. This provides for the establishment of a high level Standing Committee which will provide a forum in which the three organisations can develop a common position on any emerging problems. Within the Bank, a new internal Financial Stability Committee has been established which will be responsible for overseeing the Bank's work in monitoring and improving the stability of the financial system as a whole, and for developing policies to contain such problems as may nevertheless emerge.

There are good reasons for moving away from the traditional model of a separate regulator for each different type of activity, and therefore for including banking supervision within the FSA's remit. Financial innovation and the globalisation of markets and institutions are without doubt blurring the traditional boundaries between different forms of financial intermediation. Beyond that, there are real advantages in separating out the central bank's responsibility for the stability of the financial system as a whole from the supervision of individual banks. During the twenty years that the Bank has had formal statutory responsibility for banking supervision, the public policy interest in our activities has increasingly focused on consumer protection. This is not a natural habitat for a central bank, and may indeed produce a conflict of interest if the central bank becomes over-protective of individual institutions, thereby giving rise to moral hazard in the system as a whole.

It is, however, particularly important to ensure that the Bank's capacity to identify and address emerging systemic financial problems - those which may have a significantly disruptive effect on the financial system as a whole rather than just on individual financial institutions - is not damaged in the process of change. Indeed, in recent months we have seen a very pertinent example of the importance of keeping a close watch on the overall stability of the financial system. We have seen clear evidence in some Asian countries that good macro-economic discipline has not been sufficient to ensure financial stability, in the absence of transparent and effective financial structures for allocating capital efficiently and productively. The Bank has been very actively involved with the IMF, governments, and other central banks, and in conjunction with the major banks, to contain any immediate threat to the global financial system.

There will, nevertheless, inevitably be a serious economic aftershock from Asia, which will manifest itself in slower growth in world economic activity for some time to come. Domestic economic activity in much of Asia will inevitably be subdued, as we are already seeing, with knock-on effects elsewhere, and imbalances are likely to emerge in international trading patterns.

For those reasons, it is clearly in our interests as well as those of the Asian countries, that we help them towards recovery as far as we possibly can. That represents a difficult agenda for the future, not least because, as part of that work, it will be important to review the international arrangements for early warning systems, for addressing issues that are identified by such warnings, and - should it come to it - the international arrangements for handling such crises in the future, to see if there are ways in which the economic costs can be reduced.

The Bank's role in cases where a threat to the financial system is seen to be present may involve standing between an intermediary and the market place in order to facilitate payments and settlements which might otherwise not be completed, or providing liquidity against high-quality security on penal terms outside the Bank's normal money market operations to an institution that does not wish to appear in the market because it is under a cloud. This would not normally involve the Bank in significant financial risk. In more difficult, but fortunately rare, situations, where the failure of one institution could bring down another otherwise viable institution, the Bank may need to consider acting in the role of lender of last resort to a failing institution against poorer, less liquid assets, which therefore carry greater risk of financial loss to the Bank. This safety net is not, however, intended to protect individual institutions from failure, or the shareholders or management of those institutions, but rather to protect the stability of the financial system as a whole.

Lender of last resort assistance involves the commitment of public money. For this and other reasons - including the moral hazard of encouraging excessive risk-taking and financial fragility that would result if any institution felt that it could rely on being bailed out in the event of real difficulty - the use of such public money must in each case be carefully justified in terms of the damage that would result to the financial system and the wider economy. The Memorandum of Understanding therefore provides that the Bank and the FSA should always inform the Treasury in order to give the Chancellor the option of refusing support action. Viewed overall, these arrangements ensure that the authorities have the capacity to act to limit systemic damage when necessary, but they rightly make intervention subject to appropriate authorisation by, and accountability to, the Chancellor. Where the risks are to be carried on the Bank's balance sheet, the Bank would also need to satisfy the Court of Directors that they were manageable in relation to the size of the Bank's Capital.

During the past year, the Bank has continued to pursue actively its responsibility for seeking to ensure the effectiveness of the UK's financial services. This work is closely linked to the objectives of monetary and financial stability. As part of this work, we are continuing to seek, in conjunction with market practitioners, to improve the efficiency and security of the financial infrastructure, with a particular focus on payment and settlement systems, which in many respects are the glue that holds together the individual parts of the system. To this end, the Bank has in the past year launched a review of UK payment and settlement systems, and continued its involvement in creating the TARGET system for high value euro payments. The Bank has also been active in assessing the nature and scope of Millennium Risk within the financial sector and assisting in its preparations for the Year 2000. And, we have continued to analyse and seek to improve the relationship between small and medium-sized companies in the UK and the providers of finance to them. During the year we published the fifth annual report on small firm finance, and carried out a study of the problems facing small firms in the export sector. All of this work continues to reflect the extensive contacts between the Bank and both small and medium-sized firms and the providers of finance.

Given the change in the Bank's monetary policy responsibilities, the Chancellor announced the establishment by the Treasury of a new Debt Management Office, which became operational on 1 April this year, to take over the Bank's responsibilities for the issuance and management of the Government's gilt-edged debt, and eventually for its day-to-day cash management. Management of the gilt-edged market has been an important responsibility of the Bank from its earliest years, and in recent years the Bank has taken the lead in implementing a major programme of reforms designed to modernise the structure of the market and enhance its international competitiveness. It was plainly important that the transfer of responsibility to the Debt Management Office should be achieved seamlessly. That that has been successfully accomplished reflects great credit on the co-operative effort mounted over the past year by the team from the Debt Management Office and the Bank which worked on this exercise.

The Bank may, again following the changes announced by the Chancellor last year, manage its own pool of foreign exchange reserves, separately from those managed on behalf of the Treasury. Within limits authorised by Court, the Bank's reserves will be available for use at the discretion of the MPC in monetary policy related operations.

The changes announced last year have had a major impact on the governance, management and financing of the Bank. The prospective changes to the Bank's Court of Directors are explained in more detail on pages 22-23. Court will remain a unitary board, but the non-executive members will, after the Act comes into force, have the specific duty of reviewing the performance of the Bank, including the conduct of its financial affairs, and the procedures - though not the policy decisions - of the MPC. Moreover, they will be required from next year to report on the Bank's performance to Parliament in a separate section of the Annual Report. Below the Court, the Bank will in future be organised into three main sub-divisions - Monetary Analysis and Statistics, Financial Stability and Financial Market Operations. Each sub-division is under an Executive Director, who in turn reports to the Governors.

Important changes to the Bank's finances have also been set in motion. Cash ratio deposits - money placed by authorised banks on an interest free basis at the Bank - will be put on a statutory footing in the new Act, and for the first time building societies will become part of the scheme. The Bank is already among the lowest cost central banks in the world. The new arrangements will not only put our finances on a firm footing, but also ensure that we are properly accountable in this respect to the Court, the Government, the banks and building societies, and to the wider public.

Against this background, Court is undergoing a number of changes in its make-up. I would like to record my particular thanks to Sir David Scholey, who retired from Court at the end of February 1998 after 17 years as a member. David has been a tremendous supporter of the life and work of the Bank throughout this time. Also, Sir John Hall stepped down after two years as a member of Court. Howard Davies left the Bank last summer to become the first Chairman of the FSA. I am most grateful for his contribution to the Bank over the two years that he was Deputy Governor, and I am pleased that, in March, Howard rejoined Court, as a Non-Executive Director. I am delighted that David Clementi was appointed as Deputy Governor last summer. I am equally pleased that Mervyn King will become the Deputy Governor with responsibility for monetary stability on the introduction of the new Act. Also, with the introduction of the Act, Michael Foot, currently the Executive Director responsible for banking supervision, will leave the Bank to become Head of Financial Supervision at the FSA. I am extremely grateful to Michael for his 30 years dedicated service to the Bank. Finally, I look forward to welcoming five new Non-Executive Directors following the introduction of the Act, Roy Bailie, Graham Hawker, Sheila McKechnie, Bill Morris and Jim Stretton.

The Act also provides for the Board of Banking Supervision to move to the FSA. I would like to thank Peter Gerrard, Sir Alan Hardcastle, Sir David Scholey, Harry Taylor and Sir Dennis Weatherstone, the current members of the Board appointed from outside the Bank, and their predecessors during the 11 years that the Board has been in existence, for all the hard work that they have put in and the support that they have given to the supervisory work of the Bank.

In last year's Report I thanked the Bank staff not only for their professionalism and dedication - which are ever present features - but particularly for their great loyalty during what was already a period of rapid change in the Bank. At that time we were only just beginning to grapple with the practical implications of the further changes just announced by the Government. Since then, we have spent a great deal of time and effort on this task, and I want to thank the staff even more profoundly for their support and contribution to this work over the past year. Inevitably change on this scale has created further uncertainties and pressures, but all of the staff have reacted in a thoroughly responsible and professional way.

A major consequence of the changes is that shortly nearly 500 of our staff involved in supervisory work will move to the FSA. I would like to record here that I am very proud of the record over the past twenty years of our supervisory staff which, in spite of popular perceptions, compares very favourably with the record of banking supervision almost anywhere in the world. I recognise that it will be a very great personal upheaval for them to leave the Bank, but I am confident that they will be a major factor ensuring that the FSA and the Bank will prosper together, and co-operate very closely in their respective tasks.

The remaining Bank staff have inevitably also been subject to greater uncertainty, and a much increased workload. We have some way to go in completing all of the changes, and I am most grateful to them for their continuing support as we push ahead with these tasks.

Finally, I am glad that I shall have the opportunity to take forward this work, and help in bedding down the changes as the Bank moves forward into a new era. That will be a major priority in the period ahead.

E. A. J. George

Governor of the Bank of England

From the left: David Clementi, Deputy Governor, Financial Stability.
Mervyn King, Deputy Governor, Monetary Stability.

BANK OF ENGLAND ACT 1998

THE Bank of England Act 1998 received Royal Assent on 23 April 1998 and is to come into force on 1 June 1998. It provides that the Bank's objectives, in relation to monetary policy, shall be to maintain price stability and, subject to that, to support the Government's economic policies, including its objectives for growth and employment. The Government is to set the Bank a price stability target at least once a year. Also in relation to monetary policy, the Government's power to direct the Bank, first taken in the 1946 nationalisation, is withdrawn, although the Act provides for directions to be given in 'extreme economic circumstances'. The Act establishes the Monetary Policy Committee (MPC) as a Committee of the Bank, and sets a framework for its operations; this is described in more detail on pages 29-30. The Bank is given for the first time a statutory power to collect information for monetary policy purposes.

The Act sets no other statutory objectives for the Bank, but the Memorandum of Understanding between the Bank, HM Treasury and the Financial Services Authority (FSA), agreed in October 1997, establishes that the Bank will be responsible for the overall stability of the financial system as a whole, including the stability of the monetary system, the financial system infrastructure, the overview of the system as a whole, the conduct in exceptional circumstances of official financial operations and the efficiency and effectiveness of the financial sector. (The full text of the Memorandum was reproduced in the FSA's launch document, on pages 93-99 of the May 1998 issue of the Bank's *Quarterly Bulletin* and as Appendix I of the *Annual Report under the Banking Act for 1997/98*.) In this context, the Act provides for the transfer to the FSA of the Bank's responsibilities for the supervision of individual banks; this entails the transfer of the Bank's functions under the Banking Act 1987, the Banking Co-ordination (Second Council Directive), Section 43 of the Financial Services Act and Section 171 of the Companies Act 1989 (relating to the listing of settlement schemes).

The Act makes changes to the Court of Directors, and in their role in the governance of the Bank. The Court will comprise the Governor, two Deputy Governors, and 16 Directors all of whom will be non-executive. (The Executive Directors, while remaining part of the Bank's Executive, will no longer sit on Court.) Directors will be appointed for three years rather than four, though the Governor and Deputy Governors will continue to be appointed for five-year terms.

The Act provides for the formal creation of a Committee of all the Non-Executive Directors, with a Chairman designated by the Chancellor. While Court as a whole will be responsible for managing the affairs of the Bank, including setting its objectives and strategy, the Committee of Non-Executive Directors will be responsible for reviewing the Bank's performance in relation to the strategy, and its financial affairs. The Committee will also review the procedures followed by the Monetary Policy Committee. The Non-Executive Directors will make their own report as part of the Bank's Annual Report.

The Act makes new provisions relating to the funding and reporting arrangements of the Bank. The cash ratio deposits scheme, under which the Bank has been partly financed by the banking system on a voluntary basis, is being put on a statutory basis with the rate set by the Government, and the obligation to contribute will be extended to include building societies. For the first time, the Bank will be required, by statute, to publish an Annual Report, on broadly the basis that it has done in recent years. The Act includes a formula in which the Bank's annual dividend to HM Treasury will be 50 per cent of post tax profits, or such other sums as may be agreed - this, too, is in line with recent practice.

THE BANK'S CORE PURPOSES

SINCE 1992, the Court of Directors has approved a definition of the Bank's core purposes. This has been modified slightly over time, and has provided a basis for setting the Bank's strategic objectives and financial framework. The core purposes are set out below, and are not greatly changed by the new legislation.

As the central bank of the United Kingdom, the Bank is committed to promoting the public good by maintaining a stable and efficient monetary and financial framework as its contribution to a healthy economy. In pursuing this goal it has three core purposes; achieving them depends on the work of the Bank as a whole.

Maintaining the integrity and value of the currency. Above all, this involves maintaining price stability, as defined by the inflation target set by the Government, as a precondition for achieving the wider economic goals of sustainable growth and employment. The Bank pursues this core purpose through its decisions on interest rates taken at the monthly meeting of the Monetary Policy Committee; by participating in international discussions to promote the health of the world economy; by implementing monetary policy through its market operations and its dealings with the financial system; and by maintaining confidence in the note issue.

Maintaining the stability of the financial system, both domestic and international. This the Bank seeks to achieve through monitoring developments in the financial system both at home and abroad, including the links between individual institutions and between financial markets; and through analysing the health of the domestic and international economy; through close co-operation with financial supervisors both domestically and internationally; and through promoting sound financial infrastructure including efficient payment and settlement arrangements. In exceptional circumstances, in consultation with the Financial Services Authority and HM Treasury as appropriate, the Bank may also provide, or assist in arranging, last resort financial support where this is needed to avoid systemic damage.

Seeking to ensure the effectiveness of the UK's financial services. The Bank wants a financial system that offers opportunities for firms of all sizes to have access to capital on terms that give adequate protection to investors, and which enhances the international competitive position of the City of London and other UK financial centres. It aims to achieve these goals through its expertise in the market place; by acting as a catalyst to collective action where market forces alone are deficient; by supporting the development of a financial infrastructure that furthers these goals; by advising government; and by encouraging British interests through its contacts with financial authorities overseas.

Because the Bank is a national institution, its three core purposes relate primarily to the United Kingdom. But achieving them requires it not only to understand the international developments that may have a bearing on them, but also to co-operate actively with other monetary authorities and international organisations.

THE BANK'S STRATEGY

THE core purposes identify the Bank's broad strategic objectives. They are supplemented by an annual strategy statement, which sets out the Bank's aims for the year ahead. The annual statement thereby provides guidance to individual areas of the Bank on the activities that they should emphasise, and serves as the basis for the allocation of resources within the Bank as a whole.

The Court of Directors approved the current strategy in November 1997. The priorities for 1998/99 are shaped very largely by the changes in the Bank's responsibilities contained in the Bank of England Act 1998. Those changes mean that the Bank will face greater scrutiny from Parliament and the public, and this is reflected in the Bank's strategy.

STRATEGIC OBJECTIVES

- To build public support for low inflation and monetary stability.

- To provide the Monetary Policy Committee with the economic analysis required to set interest rates, and to strengthen further the Bank's understanding of the dynamics of the inflation process and the techniques of inflation control.

- To increase public awareness of the Bank's analysis of the economy.

- To participate in the preparatory work for European Economic and Monetary Union (EMU), including at the European Monetary Institute (which is expected to be replaced by the European Central Bank on 1 June 1998) and in the European Union Monetary Committee, in order to exert as much influence as possible on the design of the system.

- To build public, political and market understanding of the systemic aspects of financial stability and the Bank's responsibility for the overall stability of the financial system as a whole.

- To monitor and analyse market and institutional developments both in the UK and overseas, which could pose a threat to monetary or financial stability, or impede the development of effective financial markets in the service of the wider economy.

- To conduct the Bank's financial market operations with a high degree of professional competence and risk management.

- To deepen the Bank's financial market expertise as an input to its responsibilities for monetary policy and financial stability and its role in enhancing the effectiveness of the UK financial system.

- To identify market failures in the functioning of the financial system and, where the Bank has relevant expertise, contribute to their resolution.

- To continue to push forward with the reform of payment and settlement systems in the UK and abroad, and participate in the development of such systems for EMU.

- To maintain a close relationship with the Financial Services Authority and with central banks and other financial authorities overseas, and thereby to contribute to the debate on financial supervision and regulation from the point of view of the Bank's responsibility for systemic stability.

- To take a leading role in promoting efficient structures in the UK financial markets. To ensure that they keep pace with international best practice and serve the needs of the wider economy.

- To assist the UK financial sector in its practical preparations for EMU.

- To manage the Bank's resources responsibly so as not to burden either the Government or the private sector with unnecessary costs, and to satisfy the Bank's shareholder, HM Treasury, that effective use is made of the Bank's capital.

STRATEGIC AIMS FOR 1998/99

Monetary Analysis and Statistics

- To adjust to operational monetary policy independence as speedily as possible by evolving appropriate policy-making procedures and processes.

- To ensure broad public understanding of the nature of the debate within the Monetary Policy Committee, and of the inflation projection and the way in which the forecast judgments made by the Monetary Policy Committee are used to construct it.

- To upgrade work on structural economic issues, particularly those relating to the labour market and productivity performance.

- To develop further the Bank's surveillance of macroeconomic developments in the major G10 and OECD economies.

- To continue to collect, compile and publish monetary and financial statistics, which are accurate, relevant and timely.

Financial Market Operations

- To deepen the analysis and understanding of market developments as an input to the Bank's monetary and financial stability work.

- To ensure the smooth transfer of the Bank's responsibility for government funding to the Debt Management Office.

- To set up operational and management systems for running foreign exchange operations, and carrying the corresponding risk, on the Bank's own balance sheet.

- To maintain the Bank's position as 'preferred supplier' of core banking services to HM Government and the market by demonstrating superior performance and improving cost-effectiveness in all areas.

- To continue to improve the cost-effectiveness of the Bank's registration service, and to absorb the National Savings Stock Register.

Economic and Monetary Union

- To maintain the Bank's substantial involvement in the policy debates that will be conducted in the European Central Bank and elsewhere.

- To continue to assist the UK financial sector in its practical preparations for EMU so that the City of London in particular can make its proper contribution to the development of the euro as a widely used international trading and investment currency.

- To complete the Bank's own internal preparations in readiness for the start of EMU in 1999, including ensuring that the Bank's systems are ready for the introduction of the euro.

Financial Stability

- To establish a clear analytical framework for assessing systemic risk and to contribute to the development of regulatory policy from the point of view of systemic stability and efficiency.

- To establish a Financial Stability Committee to focus and co-ordinate the Bank's financial stability work and to prepare its input to the Standing Committee of HM Treasury, the Bank and the Financial Services Authority set up under the Memorandum of Understanding.

- To carry out a review of UK payment and settlement systems and take forward the Bank's involvement in TARGET.

- To develop the Bank's international surveillance capacity concentrating on the financial infrastructure of the major G10 and OECD economies and on specific potential trouble spots, for example in emerging markets.

- To develop the Bank's analysis of the UK banking sector and of other key groups such as securities houses, investment banks, insurance companies and pension funds, focusing on systemic issues.

- To increase awareness of Millennium Risk within the financial sector and to assist it in its preparations for the Year 2000.

- In the context of seeking to ensure the effectiveness of the UK's financial services, to continue to improve the mutual understanding between small and medium-sized companies and the providers of finance to them.

Printing Works

- To continue to improve the cost-effectiveness of banknote printing and to contribute to the development of the euro banknotes.

Personnel

- To implement changes to the Bank's organisation and management structure arising from the Bank of England Act 1998. These include the personnel aspects of the transfer from the Bank of banking supervision, and of the Bank taking on operational responsibility for monetary policy.

- In the light of the changes introduced by the Act, to review the Bank's staffing policies on recruitment, training and development.

Finance, IT and Property Services

- To review the Bank's financial reporting and management information processes in the context of changes introduced by the Bank of England Act 1998.

- To ensure that the Bank's systems are ready for the introduction of the euro and for the Year 2000. IT security policy will also be reviewed.

- To review the Bank's property policy in the light, particularly, of the transfer of banking supervision.

Audit

- To continue to ensure that the Bank follows best private sector market practice in internal risk assessment - for both financial and reputational risk - and control procedures, so far as is applicable to a central bank.

IMPLEMENTATION

The Operational Reviews contained in this Report show how the key areas of the Bank are applying themselves to the implementation of the Bank's strategy. The management of the Bank's finances is discussed on pages 65-67.

Non-Executive Directors from the left. Back row: Christopher Allsopp, Sir Neville Simms, Sir David Cooksey, Frances Heaton, Sir Chips Keswick, John Neill. *Front row:* Dame Sheila Masters, Sir David Lees.
Not pictured: Sir Colin Southgate, Andrew Buxton, Howard Davies.

THE COURT OF DIRECTORS

Members of the Court of Directors – 1 March 1998

Eddie George *(Governor)*

David Clementi *(Deputy Governor)*

Mervyn King *(Executive Director)*

Sir David Lees
*(Chairman, Courtaulds plc.
Chairman, GKN plc.
Director, The Royal Opera House.
Director, The Royal Opera House Pension Fund Trustees Limited.
Member, CBI Finance and General Purposes Committee.
Member, National Defence Industries Council.
Member, European Round Table.
President, Society of Business Economics.)*

Sir Colin Southgate
*(Chairman, EMI Group plc.
Chairman, The Royal Opera House.
Trustee, The National Gallery.)*

Frances Heaton
*(Director, Lazard Brothers & Co., Limited.
Deputy Chairman, W S Atkins plc.
Director, Commercial Union plc.
Director, Elementis plc.
Director, The British United Provident Association Limited.
Member, Committee on Standards in Public Life.)*

Sir Chips Keswick
*(Chairman, Hambros plc.
Director, Anglo American Corporation of South Africa Limited.
Director, The Edinburgh Investment Trust plc.
Director, De Beers Consolidated Mines Limited.
Director, IMI plc.
Director, Persimmon plc.)*

Sir David Cooksey
*(Chairman, Advent Limited.
Director, Advent VCT plc.
Director, Advent 2 VCT plc.
Chairman, Bespak plc.
Deputy Chairman, William Baird plc.
Governor, Wellcome Trust.)*

Dame Sheila Masters, DBE
*(Partner, KPMG.
Deputy President, Institute of Chartered Accountants in England and Wales.
Governor, London Business School.
Member, Inland Revenue Board.
Trustee, Reuters Founder Share Company.
Commissioner, Public Works Loan Board.)*

Ian Plenderleith *(Executive Director)*

Sir Neville Simms
*(Group Chief Executive, Tarmac plc.
Director, Courtaulds plc.
Chairman, Major Contractors Group.
Director, The Private Finance Panel Limited.)*

Michael Foot *(Executive Director)*

John Neill, CBE
*(Deputy Chairman and Group Chief Executive, Unipart Group of Companies.
Director, Business in the Community Limited.
Director, Charter plc.
Director, Royal Automobile Club.
Vice-President, Council Member and Executive Committee Member, Society of Motor Manufacturers and Traders Limited.
Vice-President, Institute of Marketing.
Vice-President, The Institute of the Motor Industry.
Vice-President, City and Guilds Institute.)*

Andrew Buxton
*(Group Chairman, Barclays Bank plc.
Director, International Commodities Clearing House Holdings.
President, British Bankers' Association.
Chairman, CBI Economic Affairs Committee.
Chairman, Overseas Project Board, Department of Trade and Industry.
Member, British Overseas Trade Board, Department of Trade and Industry.
Member, Take Over Panel.
Member, Stock Exchange Listed Companies Advisory Committee.)*

Alastair Clark *(Executive Director)*

Christopher Allsopp
(Fellow and Tutor in Economics, New College, Oxford.)

Howard Davies
(Chairman, Financial Services Authority.)

THE Bank of England Act 1946 provides for the Court of Directors to consist of a Governor, a Deputy Governor and 16 Directors, four of whom have executive responsibilities in the Bank. Members of Court are appointed by the Crown - Governors for five years and Directors for four years.

The names of the current members of the Court of Directors, together with the principal external appointments of the Non-Executive Directors, are shown on the previous page. Sir David Simon, now Lord Simon of Highbury, vacated his position as a Director of the Bank on taking up his appointment as a Government Minister on 7 May 1997. Christopher Allsopp was appointed as his successor with effect from 2 June 1997. Howard Davies resigned as Deputy Governor of the Bank on 31 July 1997 on his appointment as Chairman of the Financial Services Authority. David Clementi was appointed as his successor with effect from 1 September 1997. The terms of office of Sir David Cooksey, Dame Sheila Masters and Ian Plenderleith expired on 28 February 1998. All three were reappointed as Directors. Sir David Scholey retired as a Director on 28 February 1998 on expiry of his term of office and Howard Davies was appointed as his successor. Sir John Hall resigned as a Director on 28 February 1998, and was not replaced pending the reconstitution of Court under the Bank of England Act 1998.

Under the Bank of England Act 1998, changes to the constitution and duties of the Court of Directors will strengthen the Bank's governance and accountability. Court will comprise the Governor, two Deputy Governors and 16 Directors all of whom will be appointed by the Crown - the Governor and Deputy Governors for five years and the Directors for three years, although the initial terms of some of the Directors will be less than three years to ensure that the terms of office of all the Directors do not expire at the same time. When the Act comes into effect, the 11 serving Non-Executive Directors will be appointed to the restructured Court, together with five new Directors: Roy Bailie, Chairman of W&G Baird Holdings; Graham Hawker, Chief Executive of Hyder plc; Sheila McKechnie, Director of the Consumers' Association; Bill Morris, General Secretary of the Transport and General Workers' Union; and Jim Stretton, Chief Executive, UK Operations, Standard Life Assurance Company. Mervyn King, at present an Executive Director, will be appointed Deputy Governor. The other three Executive Directors will cease to be members of Court: Ian Plenderleith and Alastair Clark will retain the title of Executive Director; and Michael Foot will leave the Bank to take up his responsibilities at the Financial Services Authority.

The new Bank of England Act provides that Court will meet at least once a month. The functions of Court will be to manage the Bank's affairs other than the formulation of monetary policy, which will be the responsibility of the Monetary Policy Committee. This will include determining the Bank's objectives and strategy, ensuring the effective discharge of the Bank's functions and ensuring the most efficient use of the Bank's resources. The 16 Non-Executive Directors will form a sub-committee of Court. The functions of the sub-committee will include reviewing the Bank's performance in relation to its objectives and strategy, monitoring its financial management, reviewing its internal financial controls and determining the Governor's and Deputy Governors' remuneration and pensions. It will also be responsible for reviewing the procedures of the Monetary Policy Committee, and in particular whether the Committee has collected the regional, sectoral and other information necessary for formulating monetary policy. The Chancellor of the Exchequer has designated Dame Sheila Masters to chair the sub-committee, and to chair Court in the Governor's absence, as provided for by the new Bank of England Act.

When the new Bank of England Act takes effect, the Board of Banking Supervision will become a committee of the Financial Services Authority. The Board will have the same powers and advisory relationship with the Financial Services Authority as it has had with the Bank of England, at least until the proposed new financial services legislation is enacted.

From the left: John Vickers, Executive Director, Monetary Analysis and Statistics. Ian Plenderleith, Executive Director, Financial Market Operations. Alastair Clark, Executive Director, Financial Stability.

THE EXECUTIVE AND SENIOR MANAGEMENT

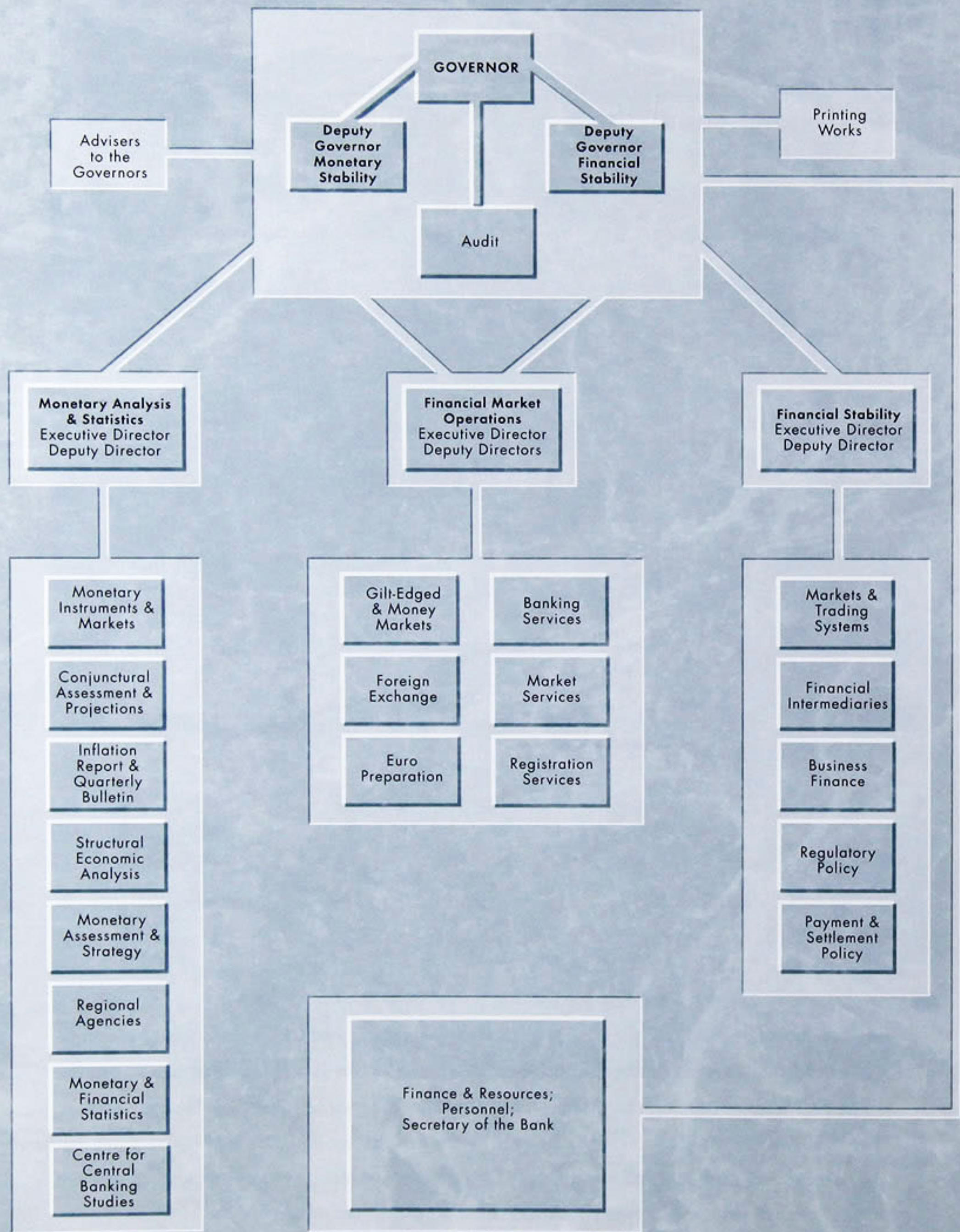
Members of the Executive and Senior Management 1 June 1998

GOVERNOR'S COMMITTEE	MANAGEMENT COMMITTEE
Eddie George *(Governor)*	David Clementi *(Deputy Governor, Financial Stability)*
David Clementi *(Deputy Governor, Financial Stability)*	Bill Allen *(Deputy Director, Monetary Analysis and Statistics)*
Mervyn King *(Deputy Governor, Monetary Stability)*	John Footman *(Deputy Director, Financial Stability)*
Alastair Clark *(Executive Director, Financial Stability)*	Graham Kentfield *(Deputy Director, Financial Market Operations)*
Ian Plenderleith *(Executive Director, Financial Market Operations)*	Gordon Midgley *(Deputy Director, Finance and Resources)*
John Vickers *(Executive Director, Monetary Analysis and Statistics)*	John Townend *(Deputy Director, Financial Market Operations)*
	Merlyn Lowther *(Personnel Director)*

UNDER Court, the Bank's senior policy-making body is Governor's Committee. The internal management of the Bank is the responsibility of Management Committee. The Bank's executive and management committee structure will be unchanged when the Bank of England Act comes into force. The membership of the Committees, once the Bank of England Act takes effect, is shown above. John Vickers, who will succeed Mervyn King as an Executive Director when the latter takes up his appointment as a Deputy Governor, will join Governor's Committee. Michael Foot, currently the Executive Director responsible for Supervision and Surveillance, and Oliver Page, the Deputy Director responsible for Supervision and Surveillance, will leave Governor's Committee and Management Committee respectively when they take up their responsibilities at the Financial Services Authority.

The Bank's new responsibilities mean that there will need to be changes in the Bank's management structure when the Bank of England Act comes into force. The new structure is shown in the organisation chart on page 26 and the names of the Heads of Function are given on page 27. There will be three operational areas - Monetary Analysis and Statistics, Financial Market Operations and Financial Stability - backed by the central support functions. There will be substantial horizontal integration across these functions and the 'one Bank' philosophy will be made concrete through continued Bank-wide teamwork and staff mobility.

THE BANK'S ORGANISATION



GOVERNORS

Eddie George *(Governor)*

David Clementi *(Deputy Governor, Financial Stability)*

Mervyn King *(Deputy Governor, Monetary Stability)*

EXECUTIVE DIRECTORS

Alastair Clark *(Financial Stability)*

Ian Plenderleith *(Financial Market Operations)*

John Vickers *(Monetary Analysis and Statistics)*

DEPUTY DIRECTORS

Bill Allen *(Monetary Analysis and Statistics)*

John Footman *(Financial Stability)*

Graham Kentfield *(Financial Market Operations, Chief Cashier)*

Gordon Midgley *(Finance and Resources)*

John Townend *(Financial Market Operations)*

ADVISERS TO THE GOVERNORS

Len Berkowitz *(Legal)*

Professor Richard Brealey *(Financial Stability)*

Sir Peter Petrie *(European and Parliamentary Affairs)*

Heads of Function

MONETARY ANALYSIS AND STATISTICS

Creon Butler *(Monetary Instruments and Markets)*

Paul Fisher *(Conjunctural Assessment and Projections)*

Neal Hatch *(Inflation Report and Quarterly Bulletin)*

Nigel Jenkinson *(Structural Economic Analysis)*

Paul Tucker *(Monetary Assessment and Strategy)*

Philip Turnbull *(Monetary and Financial Statistics)*

Maxwell Fry *(Director, Centre for Central Banking Studies)*

FINANCIAL MARKET OPERATIONS

Peter Andrews *(Gilt-Edged and Money Markets)*

Clifford Smout *(Foreign Exchange)*

Stephen Collins *(Euro Preparation)*

John Bartlett *(Banking Services, Deputy Chief Cashier)*

Mike Phillips *(Market Services, Deputy Chief Cashier)*

Geoff Sparkes *(Chief Registrar)*

FINANCIAL STABILITY

Ian Bond *(Markets and Trading Systems)*

Alex Bowen *(Financial Intermediaries)*

Peter Brierley *(Business Finance)*

Patricia Jackson *(Regulatory Policy)*

John Trundle *(Payment and Settlement Policy)*

FINANCE AND RESOURCES

Michael Craig *(Investment Unit)*

Gerry Everett *(Property Services)*

Colin Mann *(Management Services)*

PERSONNEL

Merlyn Lowther *(Personnel Director)*

PRINTING WORKS

Alex Jarvis *(General Manager)*

AUDITOR

Kevin Butler

SECRETARY OF THE BANK

Peter Rodgers

From the left. Back row: Sir Alan Budd, John Vickers, Ian Plenderleith, Dr DeAnne Julius, Professor Willem Buiter, Professor Charles Goodhart. *Front row:* Mervyn King, Eddie George, David Clementi.

THE MONETARY POLICY COMMITTEE

Members of the Monetary Policy Committee 1 June 1998

Eddie George *(Governor and Chairman)*

Mervyn King *(Deputy Governor and Vice-Chairman)*

David Clementi *(Deputy Governor)*

Sir Alan Budd

Professor Willem Buiter

Professor Charles Goodhart

Dr DeAnne Julius

Ian Plenderleith

John Vickers

The principal external activities of the Committee members appointed from outside the Bank are as follows.

Sir Alan Budd: *Non-Executive Director, Information Sciences Limited; Member Advisory Board, European Economic Research Limited.*

Professor Willem Buiter: *Professor of International Macroeconomics, University of Cambridge; Member Netherlands Advisory Council on International Affairs.*

Professor Charles Goodhart: *Norman Sosnow Professor of Banking and Finance and Deputy Director, Financial Markets Group, London School of Economics.*

Dr DeAnne Julius: *Member, Skills Task Force.*

THE legislation establishing the Monetary Policy Committee (MPC) will come into force on 1 June 1998. However, the Chancellor of the Exchequer wrote in a letter to the Governor on 6 May 1997 that all aspects of the new procedure for making and announcing decisions on monetary policy would operate *de facto* until the legislation came into force. The Committee was therefore in a position to take its first decision on interest rates within a month of the announcement that the Bank was to be given operational independence.

Professor Willem Buiter of Cambridge University and Professor Charles Goodhart of the London School of Economics were nominated by the Chancellor to join the Committee as external members, and appointed by the Bank in time for the first meeting on 5 and 6 June 1997. The other members of the Committee who attended the first meeting were the Governor, the Deputy Governor - at the time Howard Davies, now Chairman of the Financial Services Authority (FSA) - Mervyn King, Executive Director for Monetary Analysis, and Ian Plenderleith, Executive Director for Monetary Operations.

Two further members nominated by the Chancellor took up their positions later in the year: Dr DeAnne Julius, at the time Chief Economist at British Airways and now full time at the Bank, joined in September 1997; and Sir Alan Budd, Chief Economic Adviser at HM Treasury, acted as Treasury observer at meetings of the Committee, until he retired from his post in November 1997 and joined the MPC in time for its December meeting. David Clementi, appointed as Deputy Governor to succeed Howard Davies, joined the MPC in September 1997. Finally, John Vickers, Drummond Professor of Political Economy at Oxford University, joined the Bank on 1 April 1998 and will join the MPC, bringing it to its full complement of nine, when the Bank of England Act comes into effect. He will succeed Mervyn King as Chief Economist and Executive Director for Monetary Analysis. Mervyn King will remain on the MPC in his new post as a Deputy Governor and will become its Vice-Chairman.

The Bank's monetary policy objectives are to maintain price stability, as defined by the Government's inflation target, and subject to that objective, to support the Government's economic policy, including its objectives for growth and employment. The Chancellor announced the Bank's inflation target on 12 June 1997, and confirmed it in the Budget statement in March 1998. The target has been set at 2.5 per cent for retail price inflation excluding mortgage interest payments (RPIX). As Chairman of the MPC, the Governor must write an open letter to the Chancellor if inflation deviates by more than 1 per cent either side of the target, but it has not been necessary to do this during the past year.

The Bank of England Act specifies a number of detailed operational and reporting procedures relating to the MPC. It says that the MPC must meet at least monthly, its decisions must be published as soon as practicable and minutes of its meetings must be published within six weeks. The minutes must record the votes of members, each of whom has one vote. The Governor - as Chairman of the MPC - has a second, casting vote in the event of a tie. The Bank is required to publish a quarterly *Inflation Report* approved by the MPC.

In his May 1997 letter, the Chancellor also set out arrangements for the accountability of the MPC. These are now reflected in the Act and include monthly reports to the Court of Directors, which is responsible for keeping under review the procedures followed by the MPC and for determining whether the MPC has collected the regional, sectoral and other information necessary for the purposes of formulating monetary policy. Externally, there is enhanced accountability to the House of Commons, including regular evidence to the Treasury Committee. Members of the MPC have made three appearances before the Treasury Committee since June 1997, to give evidence about their decisions and processes. In October 1997, the Treasury Committee also published a report on the accountability of the Bank of England and, in February 1998, it announced that it would hold hearings on the appointment of MPC members.

Over the past 12 months, official short-term interest rates have been increased on five occasions, each time by a $^1/_4$ percentage point, in order to meet the Government's inflation target. In May 1997, the Chancellor raised rates before giving the Bank operational independence. Even so, the conclusion of the Bank's May *Inflation Report*, which took account of the rise, was that inflation would probably exceed the target two years ahead. Output growth above trend and fast money supply growth were identified as factors likely to lead to rising inflation. But it was also recognised that the appreciation of sterling since August 1996 created a policy dilemma; and there was an imbalance between the growth rate of services and of manufacturing.

At its first meeting, in June 1997, the MPC reviewed the economic situation and concluded that the evidence was consistent with the outlook described in the May *Inflation Report*. The Committee accordingly voted to raise the Bank's repo rate by a ¼ percentage point to 6.5 per cent.

The Budget on 2 July 1997 further tightened the fiscal stance. Nevertheless, the Committee felt that domestic demand was growing significantly faster than any plausible measure of potential output and agreed to raise rates by a further ¼ percentage point on 10 July.

At its August meeting, the Committee felt, despite the 75 basis points increase in official interest rates since May, that without a further tightening in monetary conditions, the most likely outcome was that the Government's 2.5 per cent inflation target would be missed. It consequently decided to raise the Bank's repo rate by a ¼ percentage point to 7 per cent. Even so, the Committee was acutely aware that the increase in sterling's value had put severe pressures on the sectors most exposed to international competition. The Committee concluded that alternative monetary policy instruments to the official interest rate could not resolve the problem. In the *Inflation Report*, which was published in the following week, the MPC concluded that monetary policy had reached a position where it was possible to pause in order to assess the direction in which the risks were likely to materialise.

In September, the Committee agreed that the evidence over the past month did not point conclusively in either direction, nor resolve the main uncertainties. In the light of that, and the conclusion in the August *Inflation Report*, the Committee voted unanimously to leave interest rates unchanged.

In October, the Committee considered whether it was appropriate to end its 'pause'. It was possible that the impact on domestic demand of the monetary and fiscal tightening earlier in the year would be sufficient to slow the economy. On this interpretation, the need for a further rise in interest rates was not yet clear. Earnings growth, which had not picked up during the year (after adjusting for the timing of bonuses), supported that proposition. A second interpretation was that the early indications of strong growth in the third quarter meant that a slowdown had at least been deferred, and so the risks to the inflation outlook were clearly on the upside. The Committee agreed that it did not, as yet, have sufficient information to feel confident in choosing between these two interpretations. The members preferred to wait another month to see how the evidence on the balance of risks accumulated. By then, work on the November *Inflation Report* would have enabled the Committee to make a new inflation forecast. As a result, the Committee voted unanimously to leave interest rates unchanged in October.

In November, there was a further ¼ percentage point rise in the Bank's repo rate. Since the Committee's decision in August to pause in order to assess the risks to inflation, the data had, on balance, been stronger than expected, and sterling had fallen back by more than expected and, the Committee voted unanimously to raise rates.

In December, the Committee agreed that there was uncertainty about where the economy was in relation to capacity and that this made the policy judgment very difficult. There had been relatively little news in the past month's data that helped resolve this question, given that the Committee had already expected a strong fourth quarter. So there was a case for waiting to see further developments. The Committee voted unanimously in favour of leaving the Bank's repo rate unchanged.

All the rate rises made by the MPC in 1997 were unanimous decisions. The first split vote emerged in January 1998. Views about the appropriate level of interest rates ranged across a spectrum. One view was that it was desirable for interest rates to be raised immediately. It seemed likely that the relationship between output growth and inflation over the next two years would be less favourable than had been anticipated in the November *Inflation Report* forecast. Furthermore, the output gap had probably already been closed and it was possible that output was above trend. Recent pay developments were a matter for concern and there were worries about asset price developments. Another view was that, although those arguments had much force, there was still considerable uncertainty about the implications of recent developments for the inflation projection. Consequently, there was a strong case for waiting until a full analysis had been carried out for the February *Inflation Report*. At the other end of the spectrum was a more sanguine view about the inflationary outlook based on the signs of slowing demand growth, the difficulty of measuring the output gap with any precision and the possible downside effects of the Asian crisis on demand in the United Kingdom. On the balance of these arguments, five members (the Governor, David Clementi, DeAnne Julius, Mervyn King and Ian Plenderleith) voted to leave rates unchanged, while three members (Alan Budd, Willem Buiter and Charles Goodhart) voted to raise rates.

The Committee remained divided in February. A number of arguments were put forward in favour of an immediate increase in interest rates. The rate of domestically generated inflation was well above 2.5 per cent, and RPIX inflation was being temporarily depressed by the one-off effect of a lower level of import and commodity prices. The labour market had continued to tighten rapidly. Equity values continued to rise rapidly. With the current account of the balance of payments projected to move rapidly into deficit, the risks to the outlook for the exchange rate were mainly on the downside, implying an upside risk to inflation. The level of output was probably already above trend, putting upward pressure on inflation. In favour of keeping rates constant, there were some signs that the economy had slowed down. There were also uncertainties about the data, which meant that it was not possible to feel confident about the outlook. There were downside risks from the possibility of weaker world activity following the Asian crisis and from the possibility of a marked fall in UK equity prices. A delayed increase in rates, even if it had to be larger than a 1/4 percentage point, might have its main effect on output during the course of 1999, when some acceleration of output was projected. Thus, delaying a rise in interest rates could lead to a smoother output path. Moreover, if the downturn in activity proved to be much sharper than expected, then an immediate increase in interest rates might have to be quickly reversed. Such a reversal could impair confidence in the economy and damage the credibility of the MPC process at this stage of its development by creating confusion about monetary policy. At the end of its February meeting, the Committee was divided with four members in favour of leaving the Bank's repo rate unchanged and four members (including, now, Mervyn King) preferring an immediate rise. The Governor exercised his casting vote in favour of no change.

In March, the Committee's assessment was that there had been only a modest amount of news since February. Consequently, the considerations were broadly the same as at the February meeting. Accordingly, each member of the Committee voted as in February and again the Governor exercised his casting vote in favour of leaving the Bank's repo rate unchanged.

In April, the Committee reviewed the main news since the February *Inflation Report*. The February *Report* had concluded that the balance of risks in the forecast implied that it was more likely than not that interest rates would need to rise at some point in order to hit the inflation target looking two years or so ahead. The Committee thought that on one view the arguments for an increase had not diminished: the economy was still operating at a level above that consistent with hitting the inflation target; and a failure to move sufficiently rapidly would require a larger correction in due course. But another view was that news over the month pointed against the need for a rise in rates: the further appreciation had delivered a tightening of policy; weaker than expected earnings growth had helped to offset concerns about the labour market; and the level of GDP in 1997 had been revised downwards. Moreover, there remained significant uncertainties about the magnitude of the slowdown in the economy that was now visible, and which was projected in the February *Inflation Report* to continue during 1998. Against this background, the cost of waiting a few months, in terms of any additional tightening that might in the event prove necessary, could well be small. On the balance of these arguments, five members (the Governor, David Clementi, Charles Goodhart, DeAnne Julius and Ian Plenderleith) voted to leave rates unchanged, while three members (Alan Budd, Willem Buiter and Mervyn King) voted to raise rates.

Regional Agents from the left: Neil Kemsley, North West (Liverpool) & Northern Ireland. Stuart Iles, Central Southern.
Wendy Hyde, Greater London. John Beverly, West Midlands.
Robin Webster, North East & Cumbria. Sue Camper, Wales.
Tony Latter, Yorkshire & the Humber.
Tony Strachan, North West (Manchester). Janet Bulloch, Scotland.
Nigel Falls, South West. Robin McConnachie, South East & East Anglia.
Not pictured: David Pennington, East Midlands.

MONETARY ANALYSIS

THE role of the Monetary Analysis Divisions has grown and developed greatly since the Government made the Bank operationally independent in monetary policy. The main function of Monetary Analysis is to provide the Monetary Policy Committee (MPC) with the economic analysis needed to make decisions about interest rates. The analysis is conveyed to the MPC at an all-day briefing meeting held each month a few days before the MPC meeting and at meetings held outside the regular monthly cycle to discuss particular topics. The briefing covers monetary conditions, demand and output, the labour market, prices and information from financial markets.

The quarterly *Inflation Report* continues to provide a comprehensive and rigorous account of the factors affecting inflation, and it provides projections of inflation and, now, output growth, over the coming two years, together with an indication of the degree of uncertainty surrounding the projections. It is now the outcome of discussion among the MPC and thus represents their views.

In addition, the minutes of the MPC's meetings are published, accompanied by an annex which summarises the analysis provided to the MPC at its all-day briefing meetings by Bank staff.

The Bank is represented in the regions by its 12 Agents. They maintain contact with businesses (around 5,000 in total), and other bodies with important roles in the economy. They report to the MPC on economic conditions as seen by businesses in their regions, by means of both monthly written reports and the oral reports to the MPC's monthly all-day briefing meeting mentioned above. A quarterly summary of the Agents' monthly written reports is published alongside the *Quarterly Bulletin* and the Agents' oral contributions to the MPC's briefing meetings are summarised in the annex to the published minutes.

The Bank aims to promote public understanding of the objectives and techniques of monetary policy, and the Agents make numerous presentations to audiences in their regions, in particular on monetary policy topics - including presentations of the *Inflation Report* - and on EMU-related issues. In addition, members of the Monetary Analysis staff visit universities to deliver lectures and participate in seminars on subjects related to monetary policy. During the year, the Bank also held three seminars for schoolteachers of A-level economics and business studies, in order to explain the objectives of monetary policy and the techniques used to achieve those objectives. The seminars were in London and Manchester; further seminars will be held in other parts of the country.

Monetary Analysis has continued to undertake extensive research activities, which have increasingly been directed towards issues identified by the MPC. Much of the research is published by the Bank in Working Papers or in summary form as speeches or articles in the *Quarterly Bulletin*, as well as in the proceedings of conferences in which members of the staff have participated.

Over the past year the Bank has published speeches or papers in the *Quarterly Bulletin* on:

- Quantifying some benefits of price stability.
- Inflation and inflation uncertainty.
- The inflation target five years on.
- Economic models and policy-making.
- The *Inflation Report* projections - understanding the fan chart.
- The information in money.
- Monetary policy and the exchange rate.
- Decomposing exchange rate movements according to the uncovered interest parity condition.
- Comparing the monetary transmission mechanism in France, Germany and the United Kingdom: some issues and results.
- Investment in this recovery: an assessment.
- The Bank's regional Agencies.
- Quantifying survey data.
- The relationship between openness and economic growth: a summary of the Bank of England Openness and Growth Project.
- Implied exchange rate correlations and market perceptions of European Monetary Union.

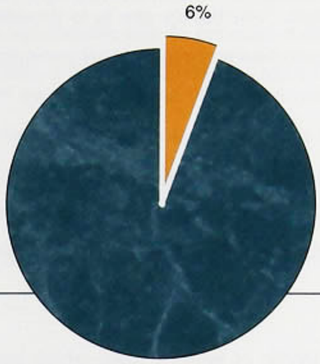
Monetary Analysis maintains close contact with economists in the academic world and in other institutions, for example through seminars and conferences. The Bank held a conference in September 1997 to discuss the results of the Openness and Growth Project, which are to be published in book form. The Bank has benefited during the year from the presence of two Houblon-Norman fellows, Alessandro Missale from the University of Brescia and Maxwell Fry from the University of Birmingham. Maxwell Fry has since joined the Bank as Director of Central Banking Studies.

In addition to its work for the MPC, Monetary Analysis has continued to contribute to the preparatory work for EMU being conducted by the European Monetary Institute, and to the work of the European Union Monetary Committee and Economic Policy Committee. Staff members also participated in other international groups organised by the G7, the G10, the International Monetary Fund, the Organisation for Economic Co-operation and Development and the Bank for International Settlements.

172 staff are currently employed in Monetary Analysis, of whom 96 are engaged in economic analysis and related management, 25 are mainly engaged in economic liaison at the Bank's Agencies and 51 are support staff, including those in the Agencies.

Monetary Analysis

PROPORTION OF THE BANK'S TOTAL COSTS



MONETARY AND FINANCIAL STATISTICS

THE Bank, through its Monetary and Financial Statistics Division, collects, processes and publishes a range of monetary and financial statistics both in support of its three core purposes and for use by Government Departments, in particular the Office for National Statistics (ONS), international organisations and private sector analysts. The Bank's aim is to provide a timely, high-quality and cost-effective service, in line with its priorities and international commitments, and with its own Statistical Code of Practice. The Division continually seeks to improve this service through reviews of the coverage and relevance of its statistics, the clarity of presentation and the cost of production. It also plays an active part in international discussions on statistical developments in many fora including the European Monetary Institute, the Bank for International Settlements, the European Union, the Organisation for Economic Co-operation and Development and the International Monetary Fund.

The Division's main task is the processing and analysis of banking data, which are used for supervision as well as monetary and financial analysis. The Bank of England Act will provide the Bank with express statutory powers for the collection of statistics which it considers necessary or expedient to have for the purposes of its monetary policy functions. The Act also provides a confidentiality regime for the information, with gateways for data to be passed to the new Financial Services Authority (FSA) and other specified authorities. The data, with those for building societies supplied by the Building Societies Commission, contribute both to measures of domestic money and credit and to measuring international credit flows and indebtedness, and are used by the Bank's Monetary Policy Committee. The Bank will also continue to collect supervisory data from banks on behalf of the FSA. The Division also compiles elements of the balance of payments, statistics on government financial transactions, official reserves and official borrowing, and other data especially relevant to the Bank's core purposes such as capital issues, interest and exchange rates and on certain non-bank financial institutions. All these data feed into the UK Economic Accounts prepared by the ONS. The Division's data supply to the ONS is governed by a 'Firm Agreement' which covers areas such as timeliness, revisions and interpretative advice. A similar 'Service Level Agreement' with the banking supervisors in the new FSA will be implemented in 1998. Finally, in support of the Bank's third core purpose, the Division provides the secretariat of the British Invisibles Statistics Committee and advises the Bank and ONS on non-bank financial institutions and on financial services statistics.

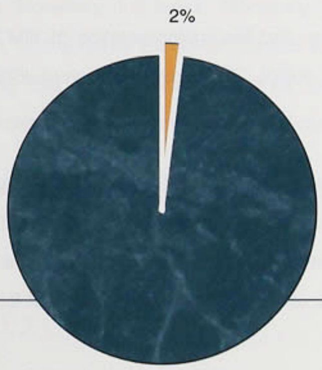
During 1997/98, the Division introduced new banking forms and definitions as part of a major review of banking statistics. This review covered requirements in relation to monetary policy and the implementation of the European System of Accounts (1995) standards, to improve the international comparability of banking and national accounts. The review also encompassed discussions with the banks on the statistical reporting requirements of the European Monetary Institute/European Central Bank. Other changes to statistical outputs resulting from the review of banking statistics included further monthly data of economic sectors' deposits and borrowing and a new quarterly survey of derivatives. A total of 26 seminars were held for staff of reporting institutions to explain the changes and the new forms.

The Bank's statistics are published monthly in *Bank of England: Monetary and Financial Statistics* and in regular statistical releases, the annual *Statistical Abstract* and by the ONS in its publications (in particular, *Financial Statistics*). All regular releases are on the Internet, and key ones are made available through wire services. The Division has also been active in seeking a closer and more interactive relationship with its principal customers. To this end it has helped to establish, jointly with the ONS, a Financial Statistics Users Group which so far has organised three major open meetings.

The Division employs 83 staff, of whom some 27 are involved in compiling and presenting data and a further 27 are engaged in analysis and interpretation. There is a senior management team of nine. The rest of the staff provide computing and clerical support.

Monetary and Financial Statistics

PROPORTION OF THE BANK'S TOTAL COSTS



MARKET OPERATIONS

THE Market Operations Divisions are responsible for the Bank's activities in the money and foreign exchange markets. They carry out the Bank's market operations, including foreign currency debt and reserves operations as agent for, and within guidelines set by, HM Treasury; contribute to the analysis of market developments for the Bank's monetary policy and financial stability responsibilities; and seek to promote efficient structures in the markets in which the Bank operates, including developing new instruments and techniques.

GILT-EDGED AND MONEY MARKETS

The Gilt-Edged and Money Markets Division is responsible for executing domestic open market operations; promoting the development and efficiency of the core sterling markets; and contributing to the technical preparations for a single currency. It monitors domestic market developments from which it provides advice to the Bank's monetary policy and financial stability work, including a presentation at the monthly briefing of the Monetary Policy Committee (MPC).

The Division has also been responsible for advice on, and the implementation of, HM Treasury's gilt-edged operations to finance the public sector deficit. Total gilt sales were £25.8 billion, including £4.8 billion of index-linked gilts.

The Chancellor announced, in May 1997, that the Bank's role as the Government's agent for debt management, the sale of gilts, the oversight of the gilt market and cash management would be transferred to HM Treasury. Bank and HM Treasury staff worked together to establish a new Debt Management Office (DMO) which began operations on 1 April 1998, and five staff from Market Operations have been seconded to the DMO.

The reform programme in the gilt-edged market has also continued. After the successful upgrading of the Central Gilts Office (CGO) in November 1997, the gilt strips market (separate trading of principal and coupons) began in December. Following an earlier consultation on gilt conventions, the Bank announced in March 1998 that on 31 July 1998 the special ex dividend period (during which a gilt can exceptionally be sold without its dividend) would be abolished; and that on 1 November 1998 the calculation of accrued interest on gilts would change to 'actual over actual', and gilt prices would be quoted in decimals rather than 32nds.

The Division is nearing completion of a new gilt management information system, which will be used both in the Division and by the DMO.

In March 1997, the Bank reformed the execution of open market operations in the money markets, with a view to facilitating wider participation and increasing transparency. Open market operations are directed to establishing short-term interest rates by providing the necessary marginal liquidity to the banking system at the interest rate set by the MPC. The reforms extended the range of instruments (to include gilt repo) against which the Bank is prepared to supply liquidity. A number of technical changes were introduced to the Bank's end-of-day operations to allow the use of later, and more accurate, forecasts of the market's liquidity position.

The reforms also widened the range of counterparties to include building societies, banks and securities houses, in addition to the specialist discount houses with whom the Bank had previously dealt exclusively. Separate transition arrangements were established for the discount houses to allow them a short period to adjust to the new environment. The Bank ended the requirement that its money market counterparties should be separately-capitalised, specialised intermediaries subject to a dedicated supervisory regime. At the same time, the requirement of separate capitalisation was dropped for the gilt-edged market makers (GEMMs), the Bank's counterparties in the gilt market. During the course of 1997, the majority of GEMMs ceased to be separately capitalised, and supervision of their gilt business moved to the Securities and Futures Authority, the Bank's Supervision and Surveillance Division, or the appropriate European Economic Area regulator depending on the structure of each firm.

The Division has been heavily involved in preparing for EMU. It has represented the Bank on the European Monetary Institute's Monetary Policy Sub-Committee, which has prepared the framework for the future European Central Bank's monetary operations in the single currency. It is ensuring that appropriate lessons for the Bank's own market operations are drawn from European experience, even whilst the UK remains outside EMU.

The annual review of the gilt market was produced, alongside the regular *Quarterly Bulletin* reviews.

FOREIGN EXCHANGE

During the past year, there has been a significant shift of emphasis in the work of the Foreign Exchange Division. Following the announcement, in May 1997, of the Bank's operational independence, the Division has devoted a bigger share of its resources to providing analysis from a market perspective as input to the new MPC process. In addition, it now participates in the implementation of monetary policy by undertaking foreign exchange swaps on the Bank's balance sheet; and preparations are under way to enable the Bank to manage its own foreign exchange holdings.

The Division's wider responsibilities remain unchanged, in particular: providing advice on, and implementing, the Government's exchange rate policy; undertaking foreign exchange and gold transactions on behalf of Government Departments and other central banks; managing the official reserves and foreign currency borrowing on behalf of HM Treasury; and preparing for the introduction of the single currency. The Bank currently provides the chairman of the G10 Gold and

Foreign Exchange Committee and staff members participate in a number of international financial groups.

Since the establishment of the MPC, the Division has provided input at the MPC's monthly briefing meeting, drawing on its analysis of developments in the foreign exchange and international capital markets. Information is drawn from a range of sources: exchange rate movements in response to economic and policy news; derivatives markets; technical chart analysis; and market anecdote – all of which help to inform the MPC's deliberations.

In January 1998, the Division's dealers began to conduct foreign exchange swaps on the Bank's balance sheet. These swaps were undertaken to provide sterling liquidity to the money market, supplementing the Bank's usual techniques; they are likely to be used from time-to-time in the future, if domestic money market conditions warrant. These transactions led to an increase in the Bank's holding of spot foreign currency, matched by equivalent forward sales. At the end of February, the Bank's holdings of foreign currency and gold totalled over $6.5 billion, about three quarters of which reflected the proceeds of foreign exchange swaps, the balance being deposits taken from central bank customers.

About half of the Division's staff are involved in the active management of the UK's foreign currency and gold reserves on behalf of HM Treasury. Performance is measured against benchmarks agreed with HM Treasury. The Division continues to organise the Government's foreign currency borrowing programme. There were no new foreign currency bond issues in 1997, but the auctions of Ecu Treasury Bills and three-year Ecu Treasury Notes were maintained. From January 1998, the latter were redesignated as Euro Treasury Notes. Once EMU begins, all payments of interest and repayments of principal will be made in euro.

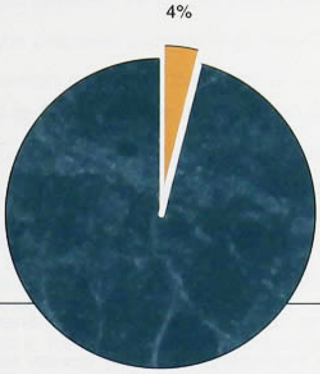
In the course of the year, the Division's new 'middle office' was brought up to full strength. Its responsibilities include measuring investment performance and monitoring the currency, interest rate and credit risks arising from the Bank's reserves management operations. This monitoring is in the process of being enhanced, with the introduction of a new management information system, scheduled for mid-1998.

Although the UK will not participate in EMU at the outset, members of the Division continued to participate in the preparations being co-ordinated by the European Monetary Institute. In the foreign exchange area, this involves designing operational frameworks for intervention and for managing the foreign reserves to be pooled with the European Central Bank. The Division is now planning actively for the internal changes that will be necessary as a result of EMU. Along with other portfolio managers, the Division and its settlement experts (in Banking and Market Services) will participate in the conversion weekend at the end of 1998.

In the year to end-February 1998, the two Market Operations Divisions had a budget of 101 staff, whose responsibilities covered dealing, portfolio management, analysis, EMU preparation and the provision of support, including management and IT. The actual number of staff was lower than this as EMU preparations were scaled back and staffing levels were adjusted ahead of the transfer of debt management. Budgeted numbers for the year to end-February 1999 have fallen to 91, although within this, the number of staff in the Foreign Exchange Division will rise slightly as a result of its additional responsibilities.

Market Operations

PROPORTION OF THE BANK'S TOTAL COSTS



ECONOMIC AND MONETARY UNION

THE announcement by the Chancellor of the Exchequer, on 27 October 1997, that the United Kingdom would not participate in EMU at the outset brought a welcome degree of clarity, but it has not diminished the intensity of the Bank's efforts to ensure that the wholesale financial services sector is ready for the introduction of the euro.

The Bank's roles are as follows:

- To ensure that the necessary UK infrastructure is developed to permit the use of the euro in wholesale payments and across the financial markets from the first day of EMU. The Bank's attention thus remains focused primarily on the wholesale financial sector.
- To help the financial community in the UK, irrespective of the nationality of ownership of individual firms, to prepare for the introduction of the euro by: explaining, as widely as possible, the relevant issues and how they are progressing; identifying areas for co-ordinated activity and cross-fertilisation; stimulating work, where necessary, within the private sector; and identifying and, where appropriate, filling gaps in the preparations.
- To promote discussion between the European Monetary Institute (EMI) and national central banks with market participants across Europe about practical issues on which the market is seeking a degree of consistency and co-ordination, but on which no single authority has the sole power to take decisions.

In January 1998, the Bank held a second symposium on the euro for senior executives from major firms active in London. The main themes were that the preparation of the UK financial sector for the euro will be complete by the end of this year, on schedule, and that London will be the international financial centre for the euro. The final session, which was chaired by the Governor and attended by the Chairmen and Chief Executives of the leading financial institutions, included reports on the day's proceedings and an address by the Chancellor. Following the symposium, a series of international roadshows - to New York, Zurich, Tokyo, Hong Kong and Singapore - was led by the Deputy Governor, to convey the message that London will be ready for the euro.

The Bank continues to publish its reports on *Practical Issues Arising from the Introduction of the Euro*, with the seventh in the series appearing in March 1998. The circulation has risen to 40,000, from 25,000 a year ago, with over 5,000 being sent abroad.

Following the recommendations of the report of the Bank-chaired market practitioner group on redenomination and market conventions, published in the April 1997 *Practical Issues*, the EMI and European Commission endorsed a statement on market conventions issued by all the relevant market associations. The Bank has subsequently sought to obtain and publicise as much detailed information as possible about the manner in which national currency debt, issued by the prospective euro-area Member States, will be redenominated into euro. It has also participated in a European Union (EU) working group considering the issues. The Bank has also actively pursued the practical details of the conversion weekend, which spans the end of 1998 and the start of 1999, during which many trades and outstanding positions in securities and cash, denominated in participating currencies, will be redenominated into euro.

The Bank has continued to play a full role in the technical preparations for EMU at the EMI in Frankfurt and in the EU Monetary Committee. At the EMI, the emphasis has shifted to the design and testing of systems. Whilst there has been progress in relation to the technical construction of TARGET (the proposed interlinking of Real-Time Gross Settlement payment systems in the EU), the key question relating to the terms of access of non-euro area Member States to intra-day liquidity remains unresolved. Significant progress has, however, been made in the areas of monetary and foreign exchange policy implementation, although some issues, such as whether to have reserve requirements, will be decided by the European Central Bank when it is set up, which is expected to be on 1 June 1998.

As well as undertaking regular surveillance of Member States' economies, considerable attention was devoted to the formulation of concepts and interpretations used in the Convergence Report, which the EMI published on 25 March 1998, as input to the decision on EMU membership which was taken by Heads of State or Government at the beginning of May 1998.

The EU Monetary Committee, which prepares the ground for meetings of the Council of Economic and Finance Ministers, has been closely involved in the preparations for EMU, including, inter alia, the preparation of decisions on the Stability and Growth Pact and ERM 2 (the successor to the current Exchange Rate Mechanism).

A Euro Preparation Division has been established within the Bank to ensure that sufficient priority is given to preparing for the euro. As well as co-ordinating the work on the City's preparations, and the Bank's contribution to the work of the EMI and EU Monetary Committee, it provides project management support for the Bank's own internal preparations for the euro.

BANKING AND MARKET SERVICES

BANKING and Market Services Divisions provide the banking infrastructure which supports all three of the Bank's core purposes. The key objective is to provide banking services to the Bank's customers in a professional, secure and cost-effective way.

BANKING SERVICES AND NOTE ISSUE

The Bank's regional branches in Newcastle, Manchester, Bristol and Birmingham were formally closed in October 1997. The issue of new notes and the receipt, authentication and destruction of soiled notes continue to be handled from Head Office, the northern Cash Centre at Leeds and the Printing Works. The commercial banks have now taken on full responsibility for the re-issue of fit notes, as indicated in last year's Annual Report. The cash operation at Head Office will be transferred to a new cash centre at the Printing Works in the summer of 1999.

The value of the note issue was £23,548 million at the end of February 1998, £1,537 million (7 per cent) larger than a year earlier.

VALUE OF NOTES IN CIRCULATION

£ Millions

End-February	1995	1996	1997	1998
£1 (1)	57	56	56	55
£5	1,072	1,067	1,047	1,034
£10	5,348	5,688	5,915	5,960
£20	7,723	8,579	9,559	10,621
£50	2,852	3,104	3,273	3,636
Other notes (2)	1,004	1,154	2,161	2,242
Total	**18,056**	**19,648**	**22,011**	**23,548**

(1) No £1 notes have been issued since 1984. The outstanding £1 notes were written off in March 1998 in accordance with the provisions of the Currency Act 1983.

(2) Includes higher value notes used internally in the Bank, for example, as cover for the note issues of banks of issue in Scotland and Northern Ireland in excess of their permitted issues.

NUMBER OF NEW NOTES ISSUED EACH YEAR BY DENOMINATION

Millions

Year to end-February	1995	1996	1997	1998
£5	308	336	335	333
£10	624	575	617	657
£20	342	326	339	349
£50	39	43	25	22
Total	**1,313**	**1,280**	**1,316**	**1,361**

There was a further reduction in counterfeiting activity during the year. Nevertheless, the Bank continues to review the security features in its notes.

The Sterling Banking Office has been heavily involved in preparations for the introduction of the euro, both in terms of analysing and implementing the changes required to fulfill the Bank's role as a central bank and in terms of the euro banking facilities that it will be making available to its customers. This has included the development of a CHAPS Euro Link to TARGET (see page 48), changes to the Bank's systems to accommodate euro payment facilities to be introduced by BACS and the Cheque & Credit Clearing Company, and presentations at euro seminars held in the Bank for a range of its banking customers.

Settlement bank facilities were implemented for the upgraded Central Gilts Office (CGO) gilt settlement system and work is in hand to smooth the introduction of the new arrangements for the Debt Management Office and the associated new cash management operations. Considerable progress has also been made towards ensuring that all the Bank's banking systems are Year 2000 compliant by the end of 1998.

The Bank has continued to administer financial sanctions (on behalf of HM Treasury) on the assets of Iraq and Libya.

MARKET SERVICES

The Market Services Division provides settlement and custody services to the Bank's customers and to the markets in general. In particular, the Division provides the 'back office' facilities for the Bank's operations in support of monetary policy, debt management and reserves management objectives. For the financial markets, it operates book-entry systems through which market participants can settle deals in gilt-edged securities (CGO) and money-market instruments (Central Moneymarkets Office). It also provides a book-entry transfer system for gold bullion for members of the London Bullion Market Association and the Bank's central bank customers.

On 3 March 1997, the Bank reformed its operations in the sterling money markets by widening the range of instruments in which it is prepared to deal to include gilt repo. The range of counterparties was also widened to include banks and security firms in the repo market. In the early days of the new arrangements the Division provided practical help and guidance to the new counterparties as well as fulfilling its extended 'back office' role.

During the year, the Division was also involved in completing the work on upgrading the CGO gilt settlement system, which went live on 10 November. The enhanced CGO service uses the software designed for CREST, the equity settlement system operated by CRESTCo Ltd, and its introduction opens the possibility of a future merger of the settlement systems for gilts and equities. The upgraded CGO also accommodates the stripping of gilt-edged stock whereby the coupon can be traded separately from the principal and reconstituted at a later date if required. This facility was introduced between the Bank and the gilt-edged market makers on 8 December 1997. In addition, the multi-currency provision in the upgraded CGO will provide a similar service to the European Settlements Office (ESO), the real-time same-day settlement facility for Ecu-denominated securities, linked to Euroclear and CEDEL, which opened in 1993. As there are advantages in providing both sterling and euro-collateral management in CGO, it was decided that the separate ESO Service should be suspended.

The Chancellor of the Exchequer's statement, on 27 October 1997, that the UK would not join EMU in 1999, but should prepare to join later, led to a review of the Bank's extensive internal preparations for the start of the single currency. It was decided that almost all the preparatory work already in progress needed to continue so that the settlement and other systems would be ready to handle euro from 1 January 1999. One of the major projects is the development of TARGET which is co-ordinated by the European Monetary Institute (EMI), to link domestic Real-Time Gross Settlement (RTGS) systems across the European Union. The technical preparations with the EMI and the CHAPS banks are now well advanced and the CHAPS Clearing Company is developing a new CHAPS Euro network which will operate in parallel with the network for sterling payments.

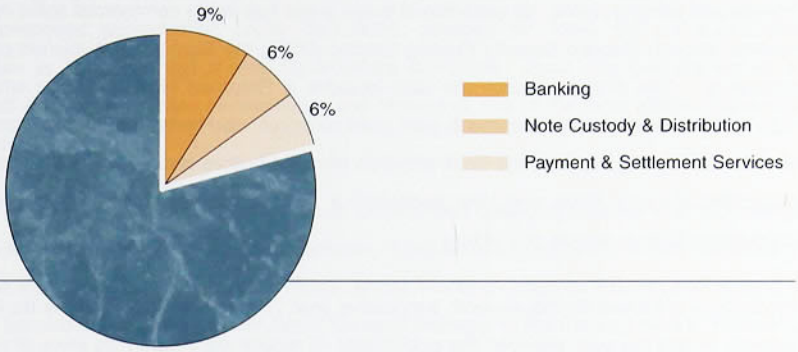
The Division has also set up several projects to ensure that the Bank's own internal computer systems can handle transactions denominated in euro from 1 January 1999. These projects include the rebuilding of the system which processes intra-day liquidity for RTGS and which settles the Bank's daily open market operations. As well as preparing to handle euro, the Division is ensuring that all its computer systems are Year 2000 compliant by the the end of 1998.

The Division has continued to play a part in facilitating international debt rescheduling operations, acting as 'escrow' agent or in a similar trustee capacity, by holding securities and/or cash which forms part of an overall settlement between the debtor country and its commercial banks. In the past year, the Bank continued to be involved in a custodial capacity in the debt rescheduling operations for Nigeria, Albania and Russia.

The Banking and Market Services Divisions employed 474 staff on 28 February 1998.

Banking and Market Services

PROPORTION OF THE BANK'S TOTAL COSTS

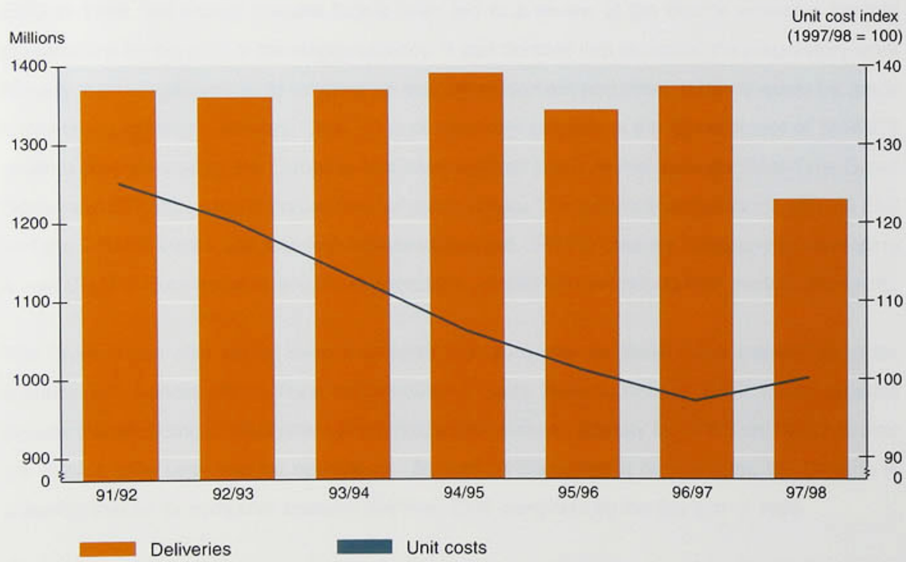


BANKNOTE PRINTING

IN addition to printing the Bank's notes, the Printing Works manufactures its own inks, security threads and printing plates. Its expertise in these areas has led to commercial sales in overseas markets through Debden Security Printing Limited (DSP), the Bank's wholly-owned commercial subsidiary. The Printing Works site also includes a Returned Note operation which, using high-speed sorting machines, authenticates used notes returned by the commercial banks prior to destruction. During the year, the Bank withdrew from the bulk re-issue of used notes suitable for dispensing through ATMs and now generates a much smaller volume of such notes as a supplement to its new note production.

Productivity improved for the eleventh successive year. The rationalisation of the Bank's branch network during the year provided the opportunity to reduce significantly its store of new notes. This led to a corresponding reduction of new note deliveries. As a result, unit costs temporarily increased by some 3 per cent.

NEW NOTE DELIVERIES AND UNIT COSTS[1]



[1] Unit cost data are not directly comparable with figures for the cost of producing Bank of England notes shown in the statements of account of the Issue Department since the latter are prepared on a cash basis.

The recent modernisation of the plant and buildings was finally completed at the beginning of the year. During the year, the Bank decided that a new cash centre should be built within surplus space at Debden. When completed, in the middle of 1999, this will take over from Head Office as the wholesale note distribution centre for southern England, complementing the northern Cash Centre at Leeds.

The Printing Works 2000 Programme, which aims to encourage staff to focus on three key values of team working, continuous improvement and customer partnership, has maintained its momentum. All teams have completed an initial review and redesign of their jobs and are now remunerated through a reward scheme which recognises the acquisition of skills and competencies. A large number of staff have volunteered for training either as Coaches to improvement groups (of which 25 are now in operation) or as Quality Auditors to assist in ensuring that the proposed accreditation under ISO 9001, planned for 1998, will be successful. Accreditation is also expected shortly for Investors in People. Such changes are aimed at involving all staff in the process of becoming, and remaining, one of the most efficient banknote printing works in the world.

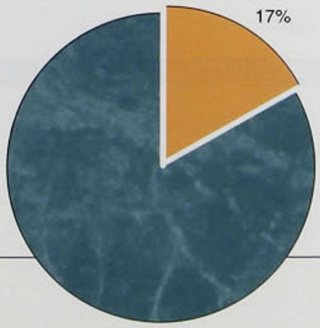
Banknote Development has continued to focus on new and emerging features and technology together with design and production improvements. Such work augments the Bank's preparatory input to the European Monetary Institute (EMI), whose Working Group on Printing and Issuing a European Banknote is chaired by Alex Jarvis, General Manager of the Printing Works. Following completion of a test printing project in 1997, the Group's final designs and specifications were approved by the EMI Council in February 1998. The Group's work is now focused through specific Project Teams (in a number of which the Printing Works is participating) whose major tasks for the coming year will be to complete origination and test printing of the seven euro banknote designs. They will also carry out a full pre-production trial, designed to test both the printing and machine sorting of all denominations, to enable production to begin from early 1999.

In its twelth year of operation, DSP achieved a turnover of £4.6 million and made a pre-tax profit of around £750,000. The substantial increase over the previous year was due mostly to a large sub-contract printing order, some benefits of which will also accrue in 1998/99. By using and paying for Printing Works' skills and operations, DSP also provides revenue for the Printing Works which, through the relief of overheads, contributes to the reduction in note issue costs charged to HM Treasury. This contribution was £2.3 million in 1997/98.

The number of staff employed by the Printing Works fell by 15 during the year to 648, (103 of whom are employed on contracts of up to two years).

Banknote Printing

PROPORTION OF THE BANK'S TOTAL COSTS



REGISTRATION SERVICES

THE Registrar's Department in Gloucester provides the principal stock registration service for the Government. The main elements of the service include issuing gilt-edged stock, maintaining the register of stockholders, registering changes of ownership of stock and making, and accounting for, interest and redemption payments.

The Department is nearing the completion of a restructuring project which was initiated to make changes designed to deliver substantial reductions in unit costs. These changes have already seen a reduction in staff numbers, the design and development of a new IT system and significant amendments to clerical procedures and will allow the Department to reduce its office space requirement later this year. HM Treasury have also agreed to the merging of the National Savings Stock Register (NSSR), currently maintained by the Department of National Savings, into the Bank Register and the necessary legislative powers are contained in the Bank of England Act 1998. This will add approximately 280,000 accounts to the Register from the middle of 1998.

NUMBER OF ACCOUNTS (000s)

End-February	1995	1996	1997	1998
British government securities	1,018	946	830	783
Non-British government securities	11	10	9	9
Total	**1,029**	**956**	**839**	**792**
Change on year				-5.6%

TRANSFERS REGISTERED (000s)

Year to end-February	1995	1996	1997	1998
Stock transfer forms	469	385	377	346
Electronic transfers through CGO	586	599	790	825
Total	**1,055**	**984**	**1,167**	**1,171**
Change on year				+0.3%

SECURITIES IN ISSUE UNDER MANAGEMENT AT THE BANK OF ENGLAND

£ millions nominal

End-February	1995	1996	1997	1998
British government securities				
Registered stock[1]	214,984	242,034	269,261	282,396
of which index-linked	*23,285*	*26,076*	*28,818*	*31,693*
Bearer bonds	23	19	17	15
	215,007	**242,053**	**269,278**	**282,411**
Change on year				+4.9%
Other securities				
Government-guaranteed	226	226	226	221
Commonwealth and overseas	3,485	3,484	3,148	3,113
Local authorities	41	41	41	41
The Agricultural Mortgage Corporation plc	22	20	0	0
Other	45	45	45	45
	3,819	**3,816**	**3,460**	**3,420**
Change on year				-1.2%
Total	**218,826**	**245,869**	**272,738**	**285,831**

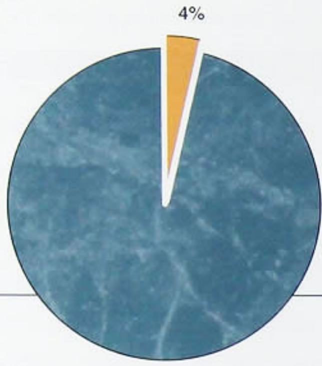
[1] including National Investment Loans Office stocks

This last year has seen the successful introduction of the upgraded CGO settlement system with its interface to the Department's registration systems, the start of the gilt strips market, interim arrangements to aid the retail brokers and preparations being made for the optional payment of gilt dividends without the deduction of income tax. As well as preparing to absorb the NSSR, the Department continues to plan for the introduction of the euro and for the possible reduction in the ex dividend period for CGO members. The Department is also preparing to work closely with the new Debt Management Office.

The Department is reducing its staff from 251 at this time last year to a total of 115 under the new structure, of whom 11 are managers, 92 are clerical staff, six are IT staff and six will be involved in Research and Development.

Registration Services

PROPORTION OF THE BANK'S TOTAL COSTS



FINANCIAL STABILITY

THE role of the Financial Stability Area is to identify and analyse developments in the structure, functioning and regulation of the financial system that are relevant either to the stability of the system as a whole, or to its efficiency and effectiveness in meeting the needs of customers. The Area's work also informs the monetary policy process and the Bank's wider central banking role; it has also been used by the Bank's supervisors. In the future, the Area will co-operate closely with the Financial Services Authority (FSA) and during the year much has been done to establish information-sharing arrangements with the new regulator.

The responsibilities of the Bank in the area of Financial Stability are set out in the Memorandum of Understanding between the Bank, the FSA and HM Treasury described on page 13 of this Report and reproduced in full in the May 1998 issue of the Bank's *Quarterly Bulletin* and in the *Report under the Banking Act Report for 1997/98.* Within the Bank, a Financial Stability Committee has been established to act as a focus for the Bank's work in this area. The Committee is chaired by the Governor; its other members are David Clementi, Mervyn King, Alastair Clark, Ian Plenderleith, John Vickers, Professor Richard Brealey and John Footman. The Committee meets monthly, and part of its role is to identify and review issues to be put forward to the Standing Committee set up under the Memorandum of Understanding. The Standing Committee includes representatives of the Bank, the FSA and HM Treasury. There are further links between the Bank and the FSA through membership of the FSA Board of David Clementi, as the Bank's Deputy Governor with responsibility for financial stability issues, and through Howard Davies' membership of the Bank's Court of Directors.

During 1997/98, a key area of work for the financial stability area has been payment and settlement systems. This has included preparation for EMU, discussed elsewhere in this Report, and especially the continuing negotiations on the TARGET system and its openness to 'out' countries. Work on minimising risk in the settlement of foreign exchange and derivative transactions has also been a priority. Two major issues arose during the year. One was the review of securities settlement in the context of a proposed merger between CGO and CREST. A consultation document was issued by the Bank in March 1998. The second was the analysis of the City's IT preparations for the Year 2000. The Bank, in co-operation with the FSA, has held meetings with a number of the financial sector's key infrastructure providers to assess their likely readiness for the millennium change. In February 1998, it published the first of a series of overviews of the City's preparations. This is likely to be an important focus in the coming year, with the emphasis on testing programmes and contingency plans.

The Regulatory Policy Division has been closely involved in a number of the issues arising from the impending transfer of responsibility for banking supervision from the Bank, and continues to provide briefing and research on broad regulatory issues. These include regulatory incentives, value at risk modelling and the measurement of credit risk. It has also taken over the representation of the Bank on a number of international supervisory committees with which the Bank will remain involved, including the Basle Supervisors' Committee.

During the year, the Financial Intermediaries Division intensified its analysis of developments in the UK banking sector as a whole. The output has been partly geared to the needs of supervisors, and will continue to be made available to the FSA. It also provides input to the Monetary Policy Committee and constitutes an important part of the analysis required by the Financial Stability Committee. The Division has continued its work on pensions, especially from the point of view of the potential financial market implications, contributing to the Government's pensions review and to the G10 working party on the economic effect of ageing. The Division has also undertaken analysis of the impact on the banking sector of the financial market crisis in the Far East. In the coming year, a separate unit is to be formed to take this work forward, in combination with support for the Bank's continuing involvement in international financial institutions and committees.

The Business Finance Division has continued to be closely involved with small firm finance issues. In February 1998, it published the fifth of the Bank's annual reports on small firm finance, which is the product of extensive contacts between the Division and those involved in the financing of the small firm sector. A particular focus this year has been the problems of smaller exporting firms. The Division is also participating in two working groups on the financing of technology-based small firms announced by the Government during the year.

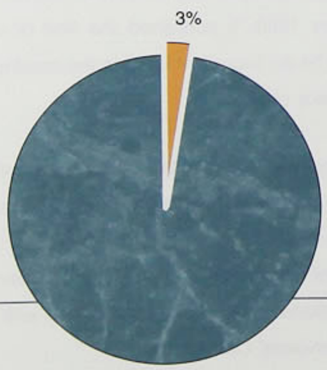
The Markets and Trading Systems Division has continued to develop its links with practitioners and exchanges in order to contribute to its assessment of market developments. Particular attention was given during the year to the European market in high-yield debt and to the changes taking place in the structure and organisation of exchanges around the world. The Division published a number of working papers and, in November 1997, led a workshop - attended by academics, regulators and policy makers - to consider a range of issues in market design. Preparations were also made for the second triennial BIS derivatives survey and for the start of regular reporting of derivatives business from 1998.

A part of the Area's work is published in the *Financial Stability Review*, two further issues of which were published during the year.

The area has 106 staff of whom 68 are in managerial and/or analytical roles.

Financial Stability

PROPORTION OF THE BANK'S TOTAL COSTS



SUPERVISION AND SURVEILLANCE

SUPERVISION and Surveillance (S&S) contributes, within the Bank, to maintaining the stability of the financial system, both domestic and international, primarily by fulfilling the statutory obligations set out in the Banking Act 1987. The Chancellor of the Exchequer announced, in May 1997, that responsibility for banking supervision would transfer to the Financial Services Authority (FSA). The transfer will take place upon the Bank of England Act coming into force on 1 June 1998. The work performed by S&S will be shared amongst a number of divisions within the FSA, with most falling within the Complex Groups Division and Banking Supervision Division.

Supervision and Surveillance has nine divisions, all of which report to an Executive Director through a Deputy Director. Two of the divisions supervise the majority of the 214 UK-incorporated banks currently authorised to take deposits in the UK and also seek to detect and, where appropriate, prosecute illegal deposit-takers. A further four supervise the 149 branches of foreign banks authorised to take deposits in the UK and most of their UK-incorporated subsidiaries. The Capital and Wholesale Markets Supervision Division brings together three areas which have a strong capital and wholesale markets content: the UK Investment Banks Group, the Traded Markets Team and the wholesale markets area (responsible for supervising the Exchange Clearing House (ECHO) and for overseeing the Financial Services Act Section 43 'wholesale markets' regime and institutions listed under Section 43). The Operational Policy Division provides advice across a range of banking supervisory issues. The Operations Division encompasses training, IT and other support functions and a Data Analysis Unit. In addition to the nine Divisions, a Quality Assurance Unit reports directly to the Executive Director and a Change Management Team reports to the Deputy Director.

During the year, S&S continued to take forward the change management programme established in July 1996 to implement the recommendations arising from the Arthur Andersen review of banking supervision. Consultative documents were issued on the Bank's enhanced approach to risk-based supervision, RATE (the framework for UK incorporated banks) and SCALE (the equivalent framework for non-EEA banks with branches in the UK), and a number of banks participated in the prototyping of RATE and SCALE during the latter half of 1997. In parallel with the prototyping, a desk-top risk assessment of all banks (excluding UK branches of EEA banks) was undertaken in order to draw up supervisory programmes for 1998. Good progress was made with the review of the Section 39 process (leading to the issue of revised notices to reporting accountants in April 1998); producing a new internal policy guide for line supervisors, which encompasses existing policy notices (which will eventually lead to the production of a guide for banks); and on the production of a new liquidity return. A Head of the newly established Quality Assurance Unit was appointed in September 1997 and the Unit undertook the first of its S&S wide reviews.

Following the Chancellor's announcement in May 1997, staff from within S&S were involved in assisting with the preparations for the transfer of banking supervision to the FSA, including contributing to the production of the report to the Chancellor in July 1997 and the launch document in October 1997. Several S&S managers have been appointed to senior management positions within the FSA.

Operationally, line supervisors were concerned with monitoring how banks responded to the emerging markets crisis, including an assessment of their stress-testing systems. Guidelines for independent risk management functions were issued in February 1998. S&S monitored banks' preparations for ensuring the adequacy of their systems for the Year 2000 and continued to monitor their preparations for EMU. With respect to capital adequacy, the Bank issued proposals to amend its policy to reflect changes brought in by the amendment to the Basle Accord to incorporate market risks and the corresponding changes to the EU Capital Adequacy Directive which are currently under discussion in Brussels.

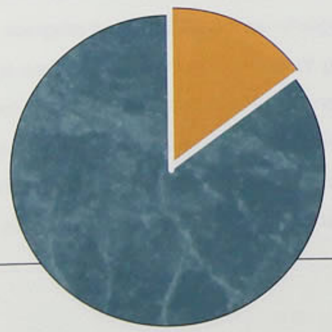
Throughout the year, S&S continued to enhance its relations with other supervisors and extended the number of Memoranda of Understanding and other forms of agreement with both UK and overseas regulators. The Bank continued to be involved in a number of multilateral initiatives, including the Joint Forum's work on how best to supervise financial conglomerates.

During the year, S&S continued to build up its resources in order to implement the change programme. The Division currently employs 434 staff, of whom 58 are senior managers, 272 are middle managers, analysts and assistants, nine are inward secondees and 95 are support staff. Within the total, the Bank has increased the number of part-time senior banking advisers, who provide support and advice to the line side, from three to five. A full breakdown of staff by division is given in the *Annual Report under the Banking Act for 1997/98*. During the year, S&S has been assisted in its work by a Legal Unit (comprising 22 staff, of whom the majority worked for S&S) and by a Special Investigations Unit (18 staff) mainly comprising forensic accountants.

Further details on the supervisory issues addressed by the Bank during the year are included in the Annual Report under the Banking Act.

Supervision and Surveillance

PROPORTION OF THE BANK'S TOTAL COSTS



CENTRE FOR CENTRAL BANKING STUDIES

THE main function of the Centre for Central Banking Studies continues to be the provision of technical assistance and training to overseas central banks. This helps other countries achieve and maintain monetary and financial stability - a worthwhile aim in itself, but one that can also bring indirect benefits to the UK where there are financial, economic, or political ties with the country concerned. The Centre has also developed the 'studies' side, with greater emphasis on comparative research between central banks.

In 1997/98, a total of 1,153 participants attended the Centre's programmes at home and abroad, a slight increase in the previous year's total of 930 reflecting a higher number of courses run abroad. For 1998, the Centre's London programme has moved yet further towards seminars and workshops. In particular in 1998, the Centre introduced a series of academic workshops drawing together participants from a variety of central banks to analyse and discuss some key issues facing central bankers. Each workshop was followed by a three-month research project involving selected participants, who looked at some of these issues in more depth. The Centre also helped organise and deliver 23 short programmes in the Bank in 1997/98 for various specialists from central banks of developing or transitional economies.

East and central Europe accounted for around 30 per cent of all overseas participants whilst a further 16 per cent originated from countries of the former Soviet Union. Combined, the proportion of participants from these areas has reduced, reflecting the Centre's policy of diversifying the training effort to other transitional and developing economies. This also recognises an increasing demand from other countries. There is increasing interest from Asia, partly bilateral and partly as a result of the UK initiative to increase the effectiveness of technical assistance to the region. The Centre has also widened seminar participation to OECD countries as the technical content has become more advanced.

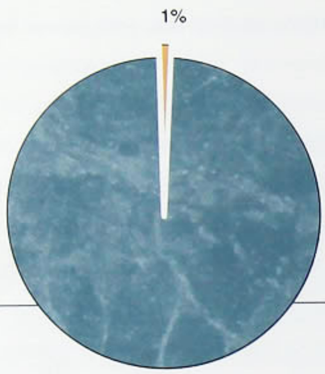
The subjects addressed in the seminars and courses have continued to evolve in response to changing demand. New areas of emphasis have included internal management and European Union issues - in particular for countries which have begun European Union accession agreements.

The Centre continues to add to the series of Handbooks in Central Banking. Fourteen titles, covering a variety of central banking topics, have now been published and more are planned.

The Centre's staff of 16 includes six advisers with a wide range of experience in most aspects of central banking and staff who provide the logistical support needed to sustain the Centre's various activities. The Centre also draws on the experience of staff elsewhere in the Bank. The bulk of the cost of the Centre's work is borne by the Bank, but some expenses are financed by the Department for International Development, the Government's Know How Fund, the British Council, the PHARE and TACIS funds of the European Commission, and the International Monetary Fund.

Centre for Central Banking Studies

PROPORTION OF THE BANK'S TOTAL COSTS

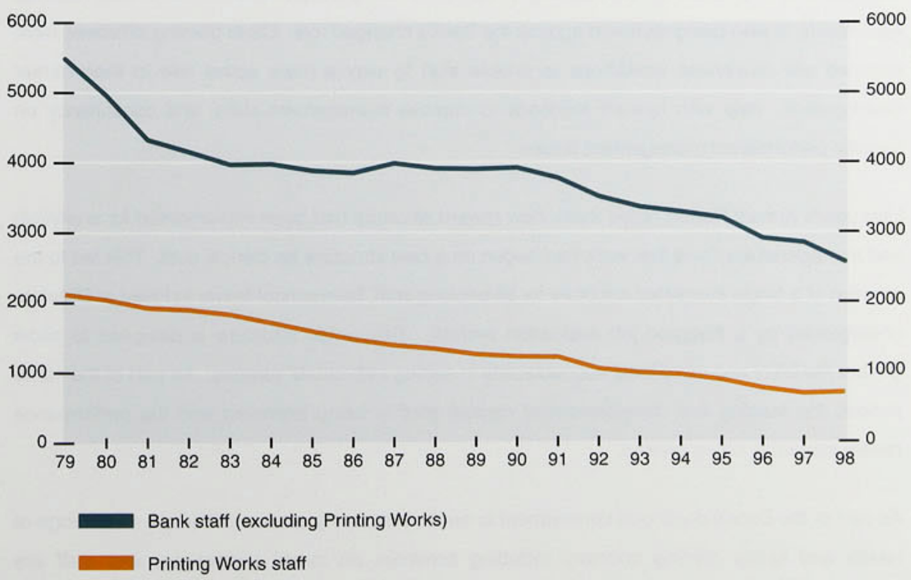


PERSONNEL

THE role of the Personnel Division is to help the Bank recruit, manage and motivate its staff in line with its changing business needs. The Division comprises four areas: Policy and Employee Relations; Training and Development; Systems and Administration; and Pensions, Loans and Welfare. The first three areas cover the core personnel role. The Pensions, Loans and Welfare area manages a number of additional functions on behalf of the Bank such as pensions administration, health and safety and the medical, dental and welfare services provided to staff and pensioners.

As at 28 February 1998, the Bank employed 3,056 full-time and 222 part-time staff. Over the past year, the overall number of staff has fallen by 280 due mainly to the closure of the Bank's remaining regional branches at the end of October, a re-organisation within the Registrar's Department in Gloucester and efficiency savings within the central support functions. Offsetting these reductions has been an increase in the number of staff engaged in project work related to preparation for the introduction of the euro and the Year 2000 and the opening of the new regional agencies. In addition to changes in the number of Bank staff, 117 staff employed by a subsidiary company, BE Services Ltd, were transferred to a new employer at the beginning of the 1997/98 financial year, as the Bank's catering function (undertaken by the subsidiary company) was outsourced.

NUMBER OF STAFF EMPLOYED BY THE BANK AT END-FEBRUARY



The transfer of responsibility for banking supervision to the newly created Financial Services Authority (FSA) will have a major impact on staff numbers when the Bank of England Act comes into force, with around 470 staff transferring. Personnel Division was required to respond quickly to the varied employment issues that arose in connection with the transfer. Although there was a presumption that staff working in Supervision and Surveillance would transfer, all staff in the Bank were given an opportunity to request to stay in the Bank or transfer. These requests were considered against the future business needs of the two organisations, taking into account the individual's preferences and supervisory experience. The staff who transfer will choose whether to accept new terms and conditions offered by the FSA or to transfer on their Bank terms.

Fifty seven high-calibre graduates joined the Bank in the normal autumn 1997 entry. The rise on previous years (50 in 1996/97, but more typically 30-40) reflected a desire to increase the number of staff in Supervision and Surveillance (see page 58). The 35 graduates recruited to work in Supervision and Surveillance joined the Bank along with the other graduate recruits but will transfer in due course to the FSA. Graduate recruitment for autumn 1998 entry is being undertaken jointly with the FSA.

The Bank has continued to recruit GCSE, A-level and secretarial staff, the overall numbers being very similar to the last two or three years.

The changes in the Bank's role, in particular the creation of the Monetary Policy Committee, increased the demand for experienced economists and finance specialists, many of whom are being recruited externally. A review of the Bank's selection procedures undertaken in connection with mid-career recruitment resulted in revised procedures for both the external recruitment of experienced staff and the promotion of existing analytical staff.

The content and focus of the training programme for graduate entrants and their internal equivalents is also being reviewed against the Bank's changed role. Other training initiatives have included self-awareness workshops to enable staff to play a more active role in their career development; help with upward feedback to improve management skills; and consultancy on specific performance management issues.

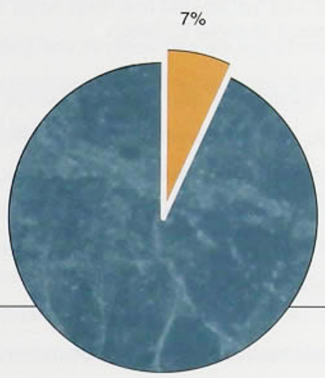
Last year's Annual Report noted that a new reward structure had been implemented for analytical and managerial staff and that work had begun on a new structure for clerical staff. This led to the creation of a single integrated structure for all banking staff, from school leaver to Head of Division, underpinned by a common job evaluation system. This single structure is designed to allow greater flexibility and more local accountability in setting individuals' salaries. As part of the same project, the training and development of clerical staff is being improved and the performance review system is being revised.

As part of the Bank's continued commitment to health and safety, staff are offered a wide range of health and safety training courses, including seminars on stress awareness, and staff are encouraged to take advantage of well-person health and fitness screenings. Once again there was a further significant reduction in the total number of reported accidents.

The Personnel Division has 93 staff, 61 of whom are engaged in core personnel work and 32 in the additional functions managed by the Division. Within the core personnel function, 24 work on training and development, 27 on administration and IT support and 10 on policy and employee relations.

Personnel

PROPORTION OF THE BANK'S TOTAL COSTS



FINANCE AND RESOURCES

THE Finance and Resources area comprises three Divisions: Finance, Property Services and Management Services.

Finance handles financial and management accounting for the whole Bank including the Bank's budgetary control system and payments to suppliers. The Investment Unit is part of the finance function in the Bank. It is responsible for the management of Banking Department's gilt portfolio and for investment of the Bank staff's pension funds (the latter under the sole guidance of its trustees). Funds under management by the unit amount to some £3 billion.

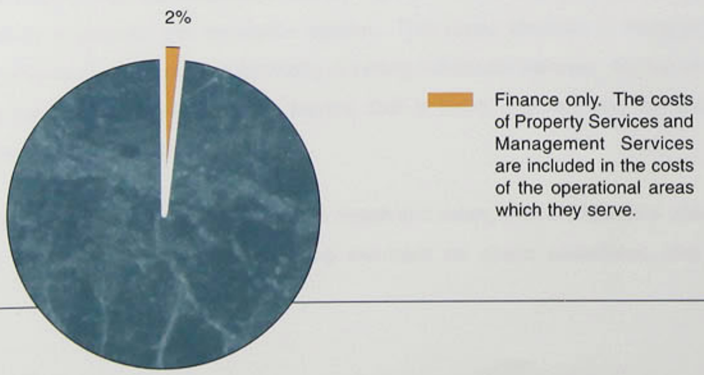
Property Services Division is responsible for all aspects of the Bank's buildings, including maintenance, office planning and space allocation, and for security. Management Services Division provides information technology and telecommunications services and technical support to all areas of the Bank. The majority of the costs of Property Services Division and Management Services Division are recharged to other areas of the Bank. The cost figures shown for the operational areas elsewhere in this Report include these recharged items.

Property Services and Management Services Divisions are responsible for implementing the main investment expenditure of the Bank. During the year, the refurbishment of Bank Buildings continued. Other work in 1997/98 included establishing the northern Cash Centre at Leeds and the new agencies. In 1998, construction work will start on the creation of a conference suite with particular relevance to meetings of the MPC. The Property Services Division will also be preparing plans to consolidate the Bank's City properties into Head Office. In keeping with the Bank's policy of giving business units prime responsibility for their own systems, the most significant IT developments are described in detail in the Operational Reviews of the user areas.

Finance and Resources employs 577 staff of whom 47 are in Finance, 386 are in Property Services including security staff, and 144 are in Management Services.

Finance and Resources

PROPORTION OF THE BANK'S TOTAL COSTS



MANAGEMENT OF THE BANK'S FINANCES

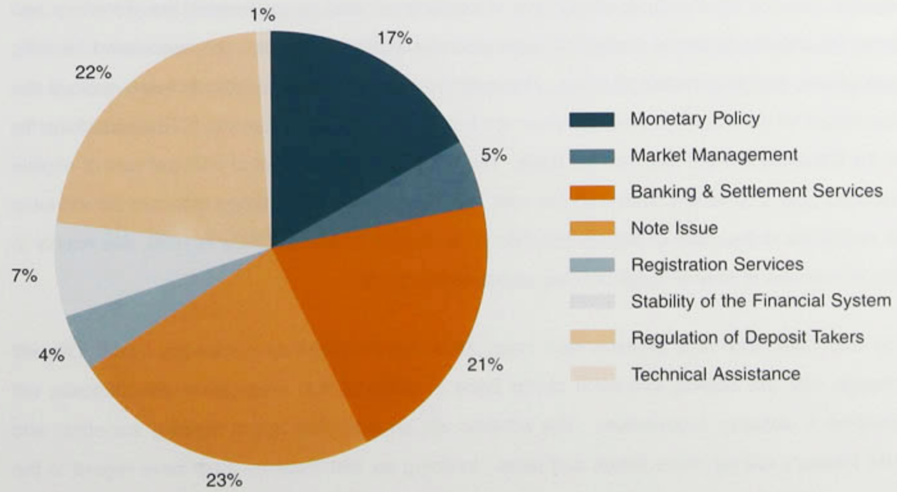
THE Bank has aimed to manage its resources and activities so as not to place an unnecessary burden on the banking community, and so as to satisfy its shareholder, HM Treasury, that it makes effective use of its capital and provides, through payments in lieu of dividend, an appropriate return. This is the financial framework within which the Bank has determined its strategy and set its budget; and it provides the background against which HM Treasury has approached the setting of cash ratio deposits under the new, statutory scheme. The Bank also aims, in relation to its finances, to be as open and transparent as it can be, following best practice in corporate reporting and explaining how its resources are raised and used. In this context, the Bank has in recent years begun to publish breakdowns of its costs, and for the future it intends to publish more information on planned expenditure.

COSTS

An indication of how the Bank's costs (calculated on the basis used internally) break down by main **organisational** area is given in the Operational Reviews on pages 35-64. Areas not included in the individual reviews are Audit (1 per cent of costs) and the Secretary's Department (5 per cent). These figures do not reflect a full allocation of central overheads.

The chart below breaks down the Bank's costs by **function**, rather than by organisational area, and also includes a full reallocation of central overheads. Total costs on this basis were £240 million in 1997/98, the same as in the previous year. There were increases in costs due largely to the continued expansion of supervision following the Arthur Andersen review, the creation of the Monetary Policy Committee and increased work on payment and settlement

TOTAL COSTS BY FUNCTION FOR 1997/98



services. However, these were offset by a reduction in other costs, mainly in relation to properties, following the completion of the refurbishment of the Printing Works.

STAFF

The table below shows the average number of people employed during the year by the Bank and its subsidiaries, including the Governors and Executive Directors, together with their aggregate remuneration.

AGGREGATE REMUNERATION AND AVERAGE NUMBER OF STAFF

	1997/98		1996/97	
	Aggregate remuneration £m	Average number of staff	Aggregate remuneration £m	Average number of staff
Bank[1]	97	3,400	97	3,722
Subsidiaries[2]	1	31	2	62
Total	**98**	**3,431**	**99**	**3,784**

[1] Includes subsidiaries whose functions are directly related to the operations of the Bank.

[2] In 1997/98, subsidiaries included NMB Group plc and Minories Finance Ltd. In 1996/97, subsidiaries also included CRESTCo Ltd, which ceased to be a subsidiary of the Bank in July 1996.

INCOME

For accounting purposes the Bank is divided into 'Issue' and 'Banking'. The Issue Department ('Issue') is solely concerned with the note issue, the assets backing the issue, the income generated by those assets and the costs incurred by the Bank in printing, issuing, sorting and destroying notes. The entire net profit of the note issue is paid over to HM Treasury.

The rest of the Bank is within the Banking Department. While the Bank recovers the costs of agency services for the Government and of banking services to customers, the monetary and financial stability functions (including supervision until mid-1998), and the associated banking operations, do not generate revenue. The main source of income to finance these costs is the investment of the Bank's capital and reserves and of the cash ratio deposits (CRDs) which banks in the UK place interest free with the Bank. The CRD rate was reduced to 0.25 per cent of eligible liabilities over £10 million, from 0.35 per cent, on 1 April 1998. The change reflected the increase in real terms in the value of eligible liabilities since the last review of CRDs in 1996, due mainly to the conversion of several large building societies into banks.

Up until 1998, cash ratio deposits have been placed by the banks on a voluntary basis. This will change with the coming into force of the Bank of England Act, when cash ratio deposits will become a statutory requirement. The scheme will be extended to the building societies, and HM Treasury will set value bands and rates. In doing so, HM Treasury must have regard to the financial needs of the Bank, and the Order setting the rates must be approved by an affirmative resolution of both Houses of Parliament. HM Treasury have proposed that with effect from 1 June 1998 the rate will be 0.15 per cent on eligible liabilities in excess of £400 million. The change reflects the widening of the scheme to building societies and the transfer of supervision to the Financial Services Authority, which will make its own charges.

BASIS OF THE BANK'S ACCOUNTS

The Bank is not subject to the Companies Acts but, in preparing the Banking Department financial statements, the Court of Directors has chosen to follow, as far as is appropriate to a central bank, requirements for banks as laid down in legislation or in accounting standards and practice. The precise basis of preparation, including the major exception considered appropriate to a central bank, is given in the Directors' Report on page 68 and in note 1 of the financial statements on page 79.

The Bank of England Act puts the above voluntary compliance onto a statutory basis and gives HM Treasury the power to require additional information relating to the accounts. The Bank, in preparing the financial statements of the Banking Department, but not the Issue Department, will, in future, be subject to requirements corresponding to those in the Companies Act, but will retain the ability to disregard such a requirement to the extent that it considers it appropriate to do so having regard to its functions. The Bank intends to use this latter provision so that it can continue with the basis of preparation as described in the Directors' Report on page 68. These financial statements, along with the Annual Report, which is also required under the Bank of England Act, will be sent to the Chancellor of the Exchequer and will be laid before Parliament.

PAYMENT IN LIEU OF DIVIDEND TO HM TREASURY

The Bank of England Act 1946 requires the Bank to pay HM Treasury, in lieu of dividend on the Bank's capital, a sum agreed between the Bank and HM Treasury. The dividend is paid in two parts. An interim dividend is paid on 5 April, based on provisional figures for the profit for the year. The final dividend is payable on 5 October. For a number of years the dividend has been based on the Bank and HM Treasury sharing post-tax profits equally, subject to individual consideration of special items.

DIRECTORS' REPORT

FOR THE YEAR ENDED 28 FEBRUARY 1998

Principal activities and review of operations

THE Bank's Core Purposes and Strategy are set out on pages 15-19. The Governor's Foreword on pages 3-11 and the Operational Reviews on pages 34-64 give a detailed account of the Bank's activities and operations during 1997/98.

Presentation of the financial statements

BANKING DEPARTMENT

Although the Bank is not governed by the Companies Acts, the Court of Directors presents the financial statements of the Banking Department so as to follow, insofar as is appropriate for a central bank, and with the major exception described below, the accounting requirements for banks as laid down in legislation or in accounting standards and practice.

In exceptional circumstances, as part of its central banking responsibilities, the Bank may act as 'lender of last resort' to financial institutions in difficulty in order to prevent a loss of confidence spreading through the financial system as a whole. In some cases confidence can best be sustained if the Bank's support is disclosed only when the conditions giving rise to potentially systemic disturbance have improved. Accordingly, although the financial effects of such operations will be included in the Department's financial statements in the year in which they occur, these financial statements may not explicitly identify the existence of such support. However, the existence of such support will be disclosed in the Annual Report when the need for secrecy or confidentiality has ceased.

As a result, the Department's financial statements disclose less detail of the constituent elements of the profit and loss account than would be required under the Companies Acts. In particular there is less disclosure in respect of interest income and expense and any provisions for bad and doubtful debts, together with consequential restrictions in detailed disclosures in the balance sheet, cash flow statement and the notes to the financial statements.

ISSUE DEPARTMENT

The statements of account of the Issue Department are prepared in accordance with the requirements of the Currency and Bank Notes Act 1928 and the National Loans Act 1968.

Financial results

The Banking Department financial statements for the year ended 28 February 1998 are given on pages 76-97 and show a profit after provisions and before tax of £179 million compared with £121 million in 1996/97.

The average interest rate during the year has been around 1 per cent higher than in the previous year. The value of the cash ratio deposits has on average increased by around 30 per cent compared to the previous year. This includes the effect of the conversion of several building societies into banks. Significant movements in provisions are described below. Overall, operating profit for the year was £58 million higher than in 1996/97.

After accounting for payment in lieu of dividend to HM Treasury of £70 million (compared with £49 million in the previous year) and a tax charge of £39 million (1996/97 £23 million), the profit transferred to reserves amounts to £70 million which compares with £49 million last year.

The accounts for the Issue Department (which are given on pages 98-99) show that the profits of the note issue were £1,528 million compared with £1,218 million in 1996/97. These profits are all payable to HM Treasury. In accordance with the Currency and Bank Notes Act 1928, the assets of the Issue Department comprise securities sufficient to cover the fiduciary note issue.

The Bank's balance sheets

The composition of the balance sheets of both the Banking and the Issue Departments reflects market conditions, in particular the Government's funding position and the extent and nature of market operations by the Bank which may be carried out in both Departments. The Government, within its own financial year which runs from April to March, aims to finance, with gilt sales and National Savings, the central government borrowing requirement, gilt redemptions and any underlying change in its foreign exchange reserves. By end-February 1998, the Government had already borrowed against a particularly large gilt redemption in March 1998, and had placed the funds with the Bank as its banker. The cash which the Government had drained from the market in this way was replaced by the Bank in its market operations, part of which were undertaken on the balance sheet of the Banking Department, funded by a deposit from the Issue Department. After the end of the Bank's financial year and after the gilt redemption, the Banking Department's balance sheet returned to a more normal size.

Provisions for support operations

The NMB Group plc has continued to realise its assets over the year. The history of the Bank's involvement with this company has been referred to in previous reports and is given in note 12 of the financial statements on pages 88-89. The Bank has been able to release £10 million of its provision for support operations. These provisions amounted to £85 million at 28 February 1998, down from £95 million in 1997 compared with a maximum of £115 million in 1993.

Retrenchment into Head Office

Following the transfer of Supervision and Surveillance to the Financial Services Authority (FSA), the Bank will require less office space to accommodate its staff. The Court of Directors has therefore decided to bring all the Bank's central London staff within the main building, Head Office, and so release its other buildings for selling or letting. This retrenchment process will be combined with a refurbishment of Head Office to modern standards. The detailed planning for this project is underway and the main work will commence once staff move out of Head Office to the FSA's new offices during the autumn of 1998. A provision of £10 million has been made in respect of the retrenchment.

Internal preparation for the Year 2000

In common with other organisations, the Bank has computer systems which may be affected by Year 2000 problems. The Bank is relatively well-placed in this respect, since most of its software is new, following major software replacement over the past six years (the worst Year 2000 problems arise in old software). But all systems nevertheless need to be checked, and, recognising this, the Bank began in 1996 to identify and remedy potential weaknesses. It has set itself a target of having its critical systems millennium compliant by the end of 1998. A Committee, chaired by the Deputy Governor, oversees the work. The Bank is also actively encouraging its suppliers and customers to ensure that they will not suffer serious Year 2000 problems.

The work is mainly being carried out by Bank staff, often in conjunction with preparations for the use of the euro and with other system upgrades. It is, of course, these new systems currently under development which will be in use when the Year 2000 arrives, and so achieving millennium compliance becomes one of many project objectives; it is not a task for a separate team of people. It is therefore not possible to estimate precisely the costs of the investigative and modification work to address the Year 2000 problem in isolation.

Governance of the Bank

The role of the Court of Directors and the names of the members of the Court, together with the principal external appointments of the Non-Executive Directors are shown on pages 21-23. The Directors' responsibilities in relation to the financial statements are set out on page 72.

The main Committees of Court during 1997/98 are given below.

Remuneration Committee

The function of the Remuneration Committee is to consider all questions relating to the remuneration of the Governors, Executive Directors and Advisers to the Governor, and to make recommendations to Court. The members of the Committee during 1997/98 were Sir David Scholey (Chairman), Sir David Lees, Sir Colin Southgate, Frances Heaton and Sir Chips Keswick.

Audit Committee

The functions of the Audit Committee are:

(a) To keep under review the internal financial controls in the Bank.

(b) To receive reports from, and review the work of, the internal and external auditors. The Committee also considers and makes recommendations on the appointment of the external auditors and their fees.

(c) To review the annual financial statements prior to their submission to Court, including consideration of the appropriateness of the accounting policies and procedures adopted.

The Committee reports its conclusions to Court. The members of the Committee during 1997/98 were Sir David Lees (Chairman), Sir David Cooksey, Dame Sheila Masters and Sir Neville Simms. The Deputy Governor, the Deputy Director (Finance and Resources) and the Auditor normally attend the meetings of the Committee.

Internal control

The Court of Directors is responsible for the system of internal financial control in the Bank and its subsidiaries. The responsibility for day-to-day operations is delegated to executive management. The system of internal financial control is based on what the Directors consider to be appropriate to the Bank's activities, to the materiality of the financial and other risks inherent in those activities and to the relative costs and benefits of implementing specific controls. It should be recognised, however, that any such system can provide only reasonable, but not absolute, assurance against material misstatement and loss. The key features of the Bank's system of internal financial control are set out below:

(i) An organisational structure that is closely aligned to the Bank's core purposes in order to provide a framework for control of its various activities. Within this structure, authority levels are defined, requiring upward referral through Heads of Function to the Executive Directors or Governors. The areas of responsibility of each Executive Director are clearly defined and are set out on pages 25-27.

(ii) A planning framework covering a five-year period, with objectives and financial targets set at each level so that they are specific to the various operational areas in the Bank.

(iii) A system of financial reporting through the Executive to Court, including forecasts and budgets which allow management to monitor the key activities and progress towards financial objectives.

(iv) Defined procedures governing approval of capital and other project expenditure. These include annual budgets, detailed project approval procedures, monitoring reports and post-implementation reviews.

(v) The appointment of experienced and suitably-qualified staff. Annual appraisal procedures exist to maintain standards of performance.

(vi) The undertaking by the Executive Directors and senior management, and subsequent reporting to the Audit Committee, of a risk-assessment exercise to identify and evaluate key risks and the resources in place to control and monitor those risks.

The system of internal financial control is subject to scrutiny by management and internal audit, the Head of which reports to the Governor. An internal audit programme is prepared annually, based on risk analysis, and is approved by the Management Committee and the Audit Committee. Monitoring the effectiveness of internal financial control is undertaken by the Audit Committee, which receives regular reports from management, from internal audit and, where appropriate, from the external auditors. It reviews the activities of the internal and external auditors to ensure comprehensive audit coverage.

On behalf of Court, the Audit Committee has reviewed the effectiveness of the system of internal financial control which operated during the period covered by this Annual Report.

The external auditors, Coopers & Lybrand, have confirmed that in their opinion, with respect to the Directors' statement on internal financial control above, the statement is not inconsistent with the information of which they are aware from their audit work on the financial statements. They were not required to perform the additional work necessary to, and did not, express any opinion on the effectiveness of the Bank's system of internal financial control.

Statement of Directors' responsibilities

The Bank of England is not formally governed by the Companies Act 1985 but has chosen, for the financial statements of the Banking Department, to comply with the accounting provisions of the Act, as applicable to banks, modified as set out in note 1 of the financial statements. The Court of Directors is responsible for ensuring that these financial statements, on the basis set out in the financial statements, present fairly the state of affairs of the Banking Department as at 28 February 1998 and of the profit for the year to that date. The statements of account of the Issue Department are drawn up in accordance with provisions agreed between the Bank and HM Treasury to implement the requirements of the Currency and Bank Notes Act 1928 and the National Loans Act 1968. The Court of Directors is responsible for ensuring that the statements of account are drawn up in accordance with these requirements.

The Court of Directors is responsible for ensuring that proper accounting records are kept, which disclose at any time the financial position of the Bank and enable the Court to ensure that the financial statements comply with the requirements set out in note 1 thereto. The Court of Directors is also responsible for safeguarding the assets of the Bank and its subsidiaries, and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The Court of Directors confirms that suitable accounting policies, consistently applied and supported by reasonable and prudent judgment and estimates, have been used in the preparation of the financial statements of the Banking Department. Accounting standards applicable in the United Kingdom have been followed in preparing the financial statements of the Banking Department insofar as they are appropriate to the basis of accounting set out in the notes to the financial statements.

Equal opportunities

The Bank remains committed to its policy of equal opportunities. Support has been given to various targeted initiatives, including Opportunity 2000, Race for Opportunity, and the Employers' Forum on Disability. Support for disabled employees has included the provision of specialist equipment and adjustments both to individuals' working environments and to the Bank's premises. Since joining Opportunity 2000 in 1991, the proportion of women in managerial and analytical ranks has risen from 15 per cent to 26 per cent, with an increasing number reaching junior and middle management. Last year's Annual Report included, for the first time, data on ethnic minority staff. The proportion of ethnic minority staff has remained almost unchanged at around 5 per cent. Although there have been year-to-year fluctuations, ethnic minority staff have, over time, come to represent an increasing proportion of managerial/supervisory staff.

During 1997, the Bank's internal working party on ethnic minority issues has made a number of recommendations for additional steps to support ethnic minority employment within the Bank. These proposals are now being discussed in area groups within the Bank.

Employee involvement

The Bank has well-established arrangements for consulting staff on matters which are likely to affect their interests. Formal and informal discussions are held on a regular basis with representatives of the recognised Trade Unions on matters relating to employment conditions. This year, the most significant changes have been the introduction of a new pay and grading structure for clerical staff and the impending transfer of staff to the Financial Services Authority. In the first case, the Bank consulted fully on the new proposals which were subsequently accepted in a ballot. Focus groups are also used when new personnel initiatives are being considered.

The staff are kept fully informed about a wide range of issues, including the objectives, performance and day-to-day activities of the Bank, through regular briefings, seminars and publications such as the fortnightly staff newspaper. Electronic mail is used to bring management and press announcements to the immediate attention of staff and a Bank-wide intranet site is under construction.

Environmental management

A majority of the white paper in the City offices is now recycled. Machinery has been installed at Head Office to shred and compact the paper which is sold for recycling. At the Printing Works, bins are provided for waste segregation. The streamed waste from these is taken by a specialist company for recycling.

Particular attention is given to energy efficiency at the time of equipment renewal and refurbishment projects. These give opportunities for improvements at marginal costs. This is resulting in a continuing reduction in energy consumption.

Payment of bills

The Bank's policy is to pay all suppliers within 30 days of receipt of a valid invoice or within specifically agreed terms of payment, if these are shorter. Sampling during the year shows that the Bank paid 96 per cent of its bills within these timescales compared with 97 per cent last year.

Community involvement

Although not a member, the Bank subscribes to the principles of Business in the Community's Per Cent Club in that it contributes no less than half a per cent of its pre-tax profit to the community. Last year the Bank contributed £1,461,000 (0.8 per cent of pre-tax profit) in support of its community programme. This covers the cost of secondments, donations to charities and to academic research, and contributions to other community-related activities. £357,000 was donated to registered charities and £94,000 to other organisations, whilst the cost of community secondments and subsidised accommodation totalled £1,010,000.

The Bank's policy on charitable giving focuses on initiatives which enable disadvantaged people to access worthwhile employment through training and on supporting the staff's community involvement. £51,600 was donated to charities and schools in recognition of the funds raised or time given by staff. The Bank also matched, on a pound for pound basis: £61,100 donated by staff and pensioners to charities under the Give As

You Earn Scheme; £10,500 of staff fund-raising; and donations totalling £16,500 made by staff and pensioners to the Diana, Princess of Wales Memorial Fund.

The Bank recognises the positive impact which its community involvement programme can have in terms of the benefits to the staff involved, the community projects in which they are active and its own reputation. Because of its position, it can also give a lead to City and other organisations. Apart from the financial support described above, the Bank encourages a range of Education Business Partnership activities, particularly in areas close to the Bank such as Tower Hamlets, Hackney and Islington. It offers work experience placements, arranges for staff to act as group facilitators at job-finding skills workshops, as interviewers at practice interview sessions, as business reading partners and as mentors to headteachers. It also supports training for staff who are school governors.

No donations have been made for political purposes.

Auditors

Coopers & Lybrand will continue as auditors of the Bank.

Date of approval

The Court of Directors approved this Report on 13 May 1998.