COURT OF DIRECTORS

During year ended 28 February 1994

Declaration Made before	Date	
		Edward Alan John George, Esq, Deputy Governor
		Rupert Lascelles Pennant-Rea, Esq, Deputy Governor
		Sir George Adrian Hayhurst Cadbury
		Sir David Gerald Scholey, CBE
		Gavin Harry Laird Esq, CBE
		Sir Martin Wakefield Jacomb
		Sir Colin Ross Corness
		Brian Quinn, Esq
		Anthony Laurie Coleby, Esq
		Mervyn Allister King, Esq
		Sir David Bryan Lees
		Professor Sir Roland Smith
		Sir Colin Grieve Southgate
		Sir Christopher Anthony Hogg
		Mrs Frances Anne Heaton
		Sir John Chippendale Lindley Keswick
		Sir Christopher Jeremy Morse, KCMG
The Governor	6. 1.94	*Pendarell Hugh Kent, Esq

* Appointed 1 January 1994

A COURT OF DIRECTORS AT THE BANK

THURSDAY 6 JANUARY 1994

Present

Edward Alan John George, Esq, Governor
Rupert Lascelles Pennant-Rea, Esq, Deputy Governor
Sir George Adrian Hayhurst Cadbury
Anthony Laurie Coleby, Esq
Sir Colin Ross Corness
Mrs Frances Anne Heaton
Sir Martin Wakefield Jacomb
Pendarell Hugh Kent, Esq
Sir John Chippendale Lindley Keswick
Mervyn Allister King, Esq
Sir David Bryan Lees
Sir Christopher Jeremy Morse, KCMG
Brian Quinn, Esq
Professor Sir Roland Smith
Sir Colin Grieve Southgate

Hugh Christopher Emlyn Harris, Esq
Ian Plenderleith, Esq

In accordance with paragraph 10 of the Charter of 1946, the Governor convened Court in the absence of the Deputy Governor, and the Executive and Associate Directors.

The Governor reminded Court that before Christmas, the Queen had approved the appointments of Mr Kent as a Director from 1 January 1994, to complete the term of office of Mr Crockett, and Mr Plenderleith as a Director for a period of four years from 1 March 1994, on the departure of Mr Coleby.

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The Court of Directors agreed that, in accordance with paragraph 11(2) of the Charter of 1946, both Mr Kent and Mr Plenderleith be appointed Executive Directors from the appropriate dates, Mr Kent continuing in his current role with his present responsibilities for Finance and Industry and the Printing Works, and Mr Plenderleith assuming Mr Coleby's responsibilities for Monetary Policy and Operations, and the supervision of the Wholesale Markets, whilst retaining his current responsibilities for the Registrar's Department.

At the Governor's invitation, Sir Adrian Cadbury, in his capacity as Chairman of the Remuneration Committee, introduced three Recommendations from the Committee relating to salaries for Members of the Executive.

He reminded Members that the Remuneration Committee had responsibility for reviewing annually the overall salary ranges for the Bank Executive. Having done so recently, the Committee recommended that there be no general increase in the salary ranges with effect from 1 January 1994. However, the Committee had considered that there was no reason why the upper limit of the Associate Directors' range should not overlap with the bottom of the range for Executive Directors, on the grounds that an Associate Director of some years' experience could well justify a salary in excess of a newly-appointed Executive Director. Accordingly, the Recommendation from the Committee was that the upper limit of the Associate Directors' range be increased to provide an overlap of £10,000 with the starting salary in the range for Executive Directors. These Recommendations were approved.

Consequent upon the appointment of Mr Kent and Mr Plenderleith as Executive Directors of the Bank with effect from 1 January 1994 and 1 March 1994, respectively, a further Recommendation of the Remuneration Committee concerning their salaries on appointment was approved.

Sir Adrian Cadbury reminded Members that there was provision for performance related increases in salary within the prescribed salary ranges for Members of the Executive. Following recent discussions with the Governor, and his colleagues on the Remuneration Committee, he said that the Committee recommended performance related increases in salary for four Members of the Executive, to be effective from 1 January 1994. The Recommendation was approved.

Finally, Sir Adrian mentioned that the Trustees of the Court Pension Scheme, of which he was Chairman, had suggested that as there were various pension scheme issues that were discretionary, these should be referred to the Remuneration Committee in future rather than to the Trustees themselves, or the Governors. He further proposed that it would be helpful in the future if there were cross membership between the Pension Scheme Trustees and the Remuneration Committee. These points were noted and will be taken forward in due course.

The Deputy Governor and the Executive and Associate Directors joined Court.

The Minutes of the Court of 16 December and the Meeting of 23 December were confirmed and those of the Meeting of 30 December, having been circulated, were approved.

At the Governor's invitation, Mr Page, the Head of Wholesale Markets Supervision Division, in speaking about the work of his Division said that it exercised its supervisory responsibilities, covering six types of financial institutions, under three separate regimes: the Red Paper, which fell fully under the Banking Act; and the Blue and Grey Papers, which fell partly under the Financial Services Act, but also in part had no statutory backing at the present time.

The Bank was supervising the gilt-edged market makers under the Blue Paper, not just in order to implement the Financial Services Act but because of the Bank's own interest in the gilt-edged market. The Bank's supervision under the Grey Paper extended to activities and firms dealing principally in foreign exchange, which was an area not covered by the

Financial Services Act. A further point was that the main focus of the Grey Paper regime was on the conduct of business and not on prudential supervision, which was the supervisory focus of the other two regimes.

Turning to the supervision of the discount houses, Mr Page said that they were the Bank's principal intermediaries in the money market with whom the Bank conducted its daily money market operation. The reduced scale of the discount houses, capital - now around £200 mn - meant that they had become less active as principals in the money markets, and much of the Bank's daily operations merely passed through them to the major banks. The reduced scale had resulted from a general lack of profitability of core discount house business, and the losses they made when they tried to diversify away from that core business. However, a profit figure of £13 mn somewhat understated the position as it included some restructuring costs for one of the discount houses. The Houses now made one third of their profit from trading on their own account in the short sterling futures contract.

Although the Bank's supervisory regime as set out in the Red Paper came under the Banking Act, it was quite different from that applied to banks by the Banking Supervision Division. There was nothing like the 8% risk asset ratio for banks. Those rules were disapplied for discount houses under the Solvency Ratio Directive. The Bank's regime focused on interest rate risk, arising from holding and trading large positions in very short maturity, relatively credit risk free, instruments.

Moving on to the gilt-edged market makers, Mr Page said that they were the Bank's counterparties in the Gilts market. They had direct access to the Bank's Dealing Room and bought either for themselves, or on behalf of clients, the gilts auctioned by the Bank. The Blue Paper regime was introduced in 1986 with Big Bang. In the early years the gilt-edged market makers had had a difficult time but since 1990 they had, in total, made profits each year. However, competition remained fierce and would increase, as there were several new entrants applying to join. The Blue Paper regime looked at the risks faced by the gilt-edged market makers in holding and trading gilts. It allowed offsets where there were good hedges of one position with another.

The next group of firms covered Stock Exchange money brokers and gilt-edged inter-dealer brokers, which were intermediaries that supported the activities of the gilt-edged market makers. The Stock Exchange money brokers lent securities to the gilt-edged market makers to cover short positions; and lent them money to finance long positions. The Stock Exchange money brokers in turn borrowed stock and money from elsewhere in the financial system. The inter-dealer brokers operated as brokers in gilts, on a matched principal basis, between the gilt-edged market makers.

The supervisory regimes concentrated on where the risks lay. With the Stock Exchange money brokers, it was principally an operational risk, ie the remote possibility that something went wrong in turning over vast quantities of securities and cash. They were largely protected from credit risk and did not face significant interest rate risks. Inter-dealer brokers faced little risk. Their capital requirement was based on their expenses, to give them some protection if business turned down.

Turning to supervision under Section 43 of the Financial Services Act, Mr Page said the Bank's main interest was to apply the London Code to the wholesale market business conducted in London by the 260 firms on the Section 43 list. The Division supervised only the capital adequacy of six non-bank principals and 20 brokers. There was no requirement to be on the list to undertake business. They could therefore be supervised by another regulator such as the SFA; or, for some business, for example foreign exchange, there may be no requirement for them to be supervised at all.

In summary, Mr Page drew the distinction between Banking Supervision Division which had one regime, the Banking Acts, applying to one type of institution (banks), whereas WMSD had three regimes covering six rather different types of institution.

He stressed that the Division was currently facing a period of immense change. There were a number of EC Directives working their way through the system, and there was also a considerable tightening up following the Bingham Report. These changes most directly affected the supervision of the discount houses, although the post-Bingham changes also impacted elsewhere, particularly in the more exhaustive investigation of possibilities of breaches of rules. He quoted as an example, the fact that after the SFA had criticised one part of Goldman Sachs the Division had to follow up to check that there were no implications for the other Goldman firms, for which they were responsible. The answer, after much work, was as had been believed at the start, that there were no such implications. The EC Directives would also affect the Division more in the future, when many of the Banking Directives will begin to apply to securities firms. For the future, there would be fundamental changes to all the regimes following on the implementation of the Investment Services Directive and the Capital Adequacy Directive in 1996. Finally, there were a string of changes resulting from actual or potential changes in the structure of the markets: for example, real time gross settlement, gilt repos, and CREST.

In discussion, Sir Chips Keswick said that he was concerned that there was an area of potential danger with gilt-edged market makers in creating a special market for arbitrage which had nothing to do with the gilts market. This was a particularly technical issue and it was agreed that it be pursued outside the meeting.

In response to Sir Colin Southgate's question about the need for discount houses, Mr Plenderleith said that the Bank needed counterparties in the market and the discount houses fulfilled that purpose. Sir Roland Smith saw WMSD's role as being essentially supervisory, but questioned whose responsibility it was to look at the strategic position. He asked if we ever opposed new firms joining the market. Mr Coleby said that the question of the number of firms arose when the market was established in 1986 and the number of applicants was greater than expected. The matter had now adjusted itself and there were fewer participants. Mr Page said that there had, in fact, been 12 orderly withdrawals but there were now 4 or 5 applicants on a waiting list.

Sir Jeremy Morse said that he felt the strategic issue was a subject that would emerge in Court's discussion on the Bank's third core purpose, but accepted Mr Page's comment that the responsibility currently rested jointly with the operational and supervisory areas in the Bank. Sir Jeremy Morse also focused on the statutory responsibility and said that he hoped that when a conflict arose between the spirit and the letter, a degree of flexibility would continue to be applied in following the spirit. In the gilts areas, where the Bank's interests went beyond the Financial Services Act, he questioned whether there was a conflict in the interests the Bank pursued. In response, Mr Page said that the Bank, for its operational interests, needed a healthy market and healthy firms in order to manage the Government's debt requirement, so there was no conflict between that and our supervisory interest.
Sir Martin Jacomb said that he felt that the system of supervision had worked well post Big Bang and was very flexible. He urged the Bank to continue in that vein.

In response to Sir Colin Southgate's enquiry about adequate resources in the Division, Mr Page said that he was looking for additional staff in the coming year. However, it was not just a question of numbers; the quality of staff was important, and in this respect he was fortunate.

Mr Quinn commented on the weekly figures and Mr Coleby spoke about the Official Reserves figures for December.

In commenting on the Treasury and Civil Service Committee Report on the role of the Bank, the Deputy Governor said that, with the exception of Ms Diane Abbott, the Committee was supportive of operational autonomy for the Bank. The substance of the Committee's Report was extremely close to Court's view except, perhaps, on the issue of governance where the Committee's view was unclear. Mr Nicholas Budgen, a member of the Committee, had the opportunity to table a Private Members' bill for a second reading in January and had said that he would use it to give effect to the TCSC's conclusions.

Sir David Lees said that there was clearly a significant level of general support for operational autonomy for the Bank, and asked what the next step forward would be. In response, the Governor said that he had not had an opportunity of seeking reactions from Government yet, but would raise the issue when he met the Chancellor of the Exchequer later that month. In the meantime, however, he suggested that it was not in the Bank's interests to try and force the pace but, in that sense, Mr Budgen's initiative was helpful in keeping the issue alive.

The Governor also drew attention to the recommendation of the Committee that the minutes of the Bank's monthly meetings with HM Treasury should be published after a suitable lag. Although the Bank may not wish to move in that direction too soon, we were nevertheless looking at the proposal in some detail.

Sir Roland Smith referred to the strong points of the Report relating to the management of the economy, but said that the Report was at its weakest on the question of corporate governance. In response to Sir Roland's suggestion that the TCSC might welcome some help or advice on these issues, the Governor said that the Bank would have an opportunity to respond to the Report and that was an area that the Bank might focus on.

Under the weekly executive report:-

(i) the Deputy Governor said that at a recent meeting of the Board of Banking Supervision he had mentioned that Members of Court had said that they felt out of touch with some of the supervisory issues. Members of the Board had said that they would be happy for minutes of their meetings to be made available to Court Members in future if that would be appreciated. Additionally, Members of Court would be welcome to attend meetings of the Board as observers, if they so wished.

Sir Jeremy Morse enquired whether it would be possible for members of the Board to appear at Court to discuss issues that might arise in the minutes. He suggested that the members of the Board might make an annual Report to Court. In response, the Governor said that as Chairman of the Board of Banking Supervision, he was very happy to pursue this with members of the Board if it was Court's wish.

(ii) the Governor mentioned that Dr Alan Greenspan, Chairman of the Board of the Federal Reserve System, would be lunching at the Bank on Wednesday 2 February and all Non-Executive Directors would be welcome to attend.

A Court Room dinner had also been arranged on 19 April when Madam Speaker would be the guest. Members of Court and their spouses were invited to attend.

(iii) the Governor said that the opening proceedings of Court the following week, 13 January, would be filmed for a Channel 4 production on the Bank, which is provisionally scheduled for showing on 27 February. It was proposed to allow the filming of part of Court's discussion on Small Firms' Finance.

G. A. Croughton Rupert Pennant-Rea
Secretary. 13 Jany 1994

A COURT OF DIRECTORS AT THE BANK

THURSDAY 13 JANUARY 1994

Present

Edward Alan John George, Esq, Governor
Rupert Lascelles Pennant-Rea, Esq, Deputy Governor
Sir George Adrian Hayhurst Cadbury
Anthony Laurie Coleby, Esq
Sir Colin Ross Corness
Mrs Frances Anne Heaton
Sir Martin Wakefield Jacomb
Pendarell Hugh Kent, Esq
Mervyn Allister King, Esq
Gavin Harry Laird, Esq, CBE
Sir David Bryan Lees
Brian Quinn, Esq
Sir David Gerald Scholey, CBE
Professor Sir Roland Smith
Sir Colin Grieve Southgate

Hugh Christopher Emlyn Harris, Esq
Ian Plenderleith, Esq

The Minutes of the last Court, having been circulated, were approved.

Details of the weekly figures and graphs relating to the state of the foreign exchanges and the domestic markets were laid before Court.

Under the weekly executive report:-

(i) Mr Kent said that the Report of the Committee on Financial Aspects of Corporate Governance, the Cadbury Committee, marked a natural end to the pioneering work that had been done by PRONED. Accordingly, the Bank, as one of the sponsors of PRONED together with the BBA, the CBI, the London Stock Exchange and others, had agreed that the time had come to sell PRONED. Three willing buyers had been identified. The sale had proceeded with one of them, which was a management buy-out in conjunction with Egon Zehnder. This had taken place earlier that week and a public announcement would be made shortly. The consideration involved had been slightly in excess of £250,000: this would be shared among the sponsors, with the Bank receiving something of the order of £50,000.

Sir Adrian Cadbury said that he had been anxious to launch PRONED in the commercial world and he was very satisfied with the outcome. He would be remaining as Chairman for the meantime, and was particularly grateful to the Bank for their support, and good offices in effecting the sale. In reply, the Governor said that the Bank was extremely grateful to Sir Adrian for his inspiration and leadership of PRONED over the years.

(ii) The Governor said that he had attended the first meeting of the EMI in Frankfurt earlier that week. Members had been welcomed warmly by the Lord Mayor of Frankfurt. As the EMI did not yet have a building of its own, the meetings were held in the Frankfurt Town Hall. Members had inspected two buildings which might provide a permanent home for the EMI, the Messeturm building and the Poseidon building, but opinion had been sharply divided about their suitability. In the meantime, therefore, meetings would continue to take place in Basle. Among the other issues that had been on the agenda was the election of Mr Maurice Doyle, the

Governor of the Central Bank of Ireland, as Vice-President of the EMI. A number of other issues had also been considered, including the relationship between the staff of the EMI and national central banks, and between the EMI and other European Union institutions.

In response to Mr Laird's enquiry about electronic links between member banks and the EMI, the Governor said that such links were in place between the BIS and member banks and so there would be no difficulties whilst meetings continued to be held in Basle. Once the EMI moved into its own building in Frankfurt, it would be important to establish an IT network with member central banks. It was the intention to appoint someone to put this into effect.

The Governor explained that he had hoped to discuss Small Firms Finance at Court that day, ahead of the speech which he would be giving to the CBI in Scotland the following Monday. In view of the rather full agenda, however, he proposed to defer the discussion.

At the Governor's invitation and with the agreement of Members of Court, [redacted], attended Court for the discussion of the Report of the Community Affairs Committee.

In introducing the Report, Sir Roland Smith said that, in reviewing the Bank's community involvement, the Committee had focused on those involvements which were not close to core activities, ie charitable donations and the activities of the Community Affairs Unit. Other activities which, on a broad definition, might be classed as community involvement - such as the Centre for Central Banking Studies - had been seen as linked to the Bank's core purposes, and were funded and monitored at operating unit level.

The Committee had noted the trend for business generally, through commercial self-interest, to give increased priority to community involvement. In the Bank's case, such commercial arguments did not apply in the same way; but the majority view on the Committee was that the Bank's position in the City and its interest as an employer together made a persuasive case for there to be an active, focused approach to community involvement. Because of its different visibility and range of functions, the majority of the Committee did not see HM Treasury as an appropriate analogue for the Bank on this matter.

The proposed way forward rested on defining the parameters of the Bank's future community involvement in a policy statement - a draft accompanied the Report - and devolving operating responsibility to the Director, Corporate Services. The latter would report to Court twice a year, at the time of the discussions on the Annual Report, and of the annual long Court on internal matters in September. Sir Roland asked Court to agree these proposals and, in consequence, to stand down the Community Affairs Committee.

Members of Court made various comments on the Report. Sir David Scholey asked how the appropriation of monies for community involvement would be agreed; suggested that one Report to Court each year on community involvement would be adequate; and, in the context of the Bank's existing support for Enterprise Agencies, queried whether the Bank should focus more on national initiatives, especially those relating to its financial constituency. Sir Colin Corness asked if the Committee had addressed the question of whether scattering small donations widely was appropriate, and Sir David Lees queried how much detail the Bank was ready to put in its Annual Report. Sir Adrian Cadbury stressed the importance of supporting causes which staff were ready to support and, in one sense, suggested that this would help to narrow the Bank's field of charitable activity. This was endorsed by Sir Colin Southgate, who also noted that a new policy would take time to bed down and should not be reviewed for, perhaps, three years.

In responding to these comments, Mr Harris said that the allocation of resources to community involvement would be part of the annual budgetary process. The reporting to Court could be subsumed within the discussions on the Annual Report and on internal matters, rather than being presented as a specific item on community involvement. Details of the current community involvements, narrowly defined, had been included in the Annual Report for several years without attracting attention from HM Treasury, Parliament or the press; he acknowledged, however, that the TCSC might be taking a closer interest in the Report in future and agreed with Sir David Lees that the inclusion of a statement of principles might provide a new focus of attention. It would, in Mr Harris's view, be undesirable to publish full financial details of the various activities, related to core purposes, which might fall within a broad definition of community involvement. Enterprise Agencies were the main beneficiaries of the Bank's community secondment programme and particularly those which served inner city areas or were close to where staff lived.

On the question of the scattering of donations, Mr Harris said that the Committee had not reached a conclusion. This was a matter he would wish to pursue. He noted that the consensus of Court was to favour fewer but bigger commitments and, in particular, the need to encourage the active participation of staff. A start on this had been made through a number of employee volunteering initiatives, particularly in the run-up to Christmas.

The Governor said that the draft policy statement needed more work, not least because it referred to the statement of the Bank's Purposes, Responsibilities and Philosophy, which was not a published document. A revised policy statement might conveniently be considered at the time of the discussions on the Annual Report. He noted that the consensus of Members favoured the reporting to Court of community involvement activities as part of the annual Report and budgetary presentations, with policy being reviewed at three year intervals.

The Governor thanked Sir Roland for his report, and Court agreed that the Community Affairs Committee should be stood down.

In presenting the Economic and Financial Report for December, Mr King said that we have been conducting our post-Christmas analysis of the economy, and we have been visited by the ghosts of Christmas-past, Christmas-present, and Christmas-future.

As far as Christmas-past is concerned, most of the official statistics on output and activity tell us more about last Christmas than this. The recovery has continued for at least eighteen months, but the latest data on the growth rate of total output, non-oil output, and manufacturing output showed a rather modest rate of recovery. Between the third quarter of 1992 and the third quarter of last year, total output rose by just over 2%, non-oil output by 1.8%, and manufacturing by even less. It was difficult, however, to take the manufacturing output figures at face value. There were several reasons - discussed on page 12 of the MEFR - for thinking that the official data understated the rise in manufacturing output.

On Christmas-present, there were a number of reports of higher retail sales and activity around Christmas. The official data will be released next week. But from unofficial data we have obtained from the British Retail Consortium, there appears to be a sharp rise in sales during December with some modest fallback in January. There will be great difficulties this year in disentangling the changes around Christmas, because of the change in the seasonal pattern between last year and this. The rise in both retail sales and narrow money around Christmas was substantial, and it was not easy to make inferences about small changes in annual growth rates from the large absolute changes during this period. One set of statistics which did indicate an increase in activity was the sharp fall in unemployment - a fall of 50,000 in December. It was not easy to reconcile the statistics on output and unemployment, and the views of Members of Court would be especially welcome on this issue.

On Christmas-future, there will have been a significant rise in taxation on households by next Christmas. What effect will this have on spending? The economic analysis was quite clear - but unfortunately there were three such clear analyses, and they differ in their implications for policy. First, households who have 'super-rational' foresight might have anticipated well over a year ago that a Government at some point or another would have to raise taxes to deal with the deficit. In that case it would have been rational to lower consumption then, to reflect the reduction in long-term incomes. The announcement of tax increases in 1993, and their introduction in the period 1994-96, would have no effect on consumer spending, because this would already have come into effect some years earlier. Second, households with foresight might have adjusted their spending plans immediately after the announcement of the tax increases - both in April 1993 and in December last year. We might see some impact on spending by such households during the early part of this year. Finally, it may be that taxes affect spending only when the cash impact of higher taxes affects disposable incomes. In this case spending would start to fall - relative to where it would otherwise have been - in the summer and autumn of this year.

What does all this mean for policy? The framework is clear: we look at the prospects for inflation some two years ahead. Since the last discussion of the MEFR at Court, there have been three main pieces of news. First, the recent inflation data have been very encouraging and much lower than anticipated. There was likely to be much less of a blip during 1994 in the Government's target measure of inflation. Second, there was the Budget, which announced a significant attack on the prospects of future deficits. Third, there was the anecdotal evidence of a pick-up of spending during the Christmas period. In order to assess the news on future inflation, it was necessary to weigh up the impact of the acceleration in the rate of growth that we have seen so far against the likely depressing effects of future tax increases. This judgement was made more difficult by the recognition that there were significant lags between changes in monetary policy and their impact on activity and inflation. The current situation was rather unusual, and presents an interesting challenge in the coming months for monetary policy.

In introducing the monetary policy discussion, Mr Coleby said that the monetary indicators suggested that the recovery was continuing, and perhaps accelerating. M0 and currency circulation had increased by 5 3/4% year-on-year, and even M4 had picked up to record its highest growth rate for over a year, of 4.9%. The weakest statistic was its lending counterpart which had remained steady for six months, increasing at the rate of 3% year-on-year. Borrowing demand from the corporate sector remained weak, reflecting continued balance sheet restructuring and improving cash flow, which reduced corporate need for bank financing. Monetary data as a whole, therefore, indicated that economic recovery was becoming more firmly established.

The main question for policy continued to be the robustness of the recovery to absorb the impact of the tax changes, which would come into effect in the Spring. At the present time, with improving sentiment, it looked as if easing was not immediately necessary, but we were in the comfortable position of being able to do so if indicators suggested that the recovery was faltering.

In the discussion which followed, Mr Laird said that from his experience current increases in earnings were of the order of 2%, based on inflation expectations. In his opinion there would be no more "nil increases", but there was growing confidence that inflation would remain low.
Sir Martin Jacomb said that although retail sales were sustained, people were still looking for value for money. He remained concerned about the sterling/D-Mark exchange rate, which continued to have a significant effect on exporters: he still regarded the trade balance as the rock just beneath the surface.

From his experience, Sir Colin Southgate said that recent demand in the UK, Europe and the USA had been good. Sales in the UK had been better than forecast, with November and December 1993 very good months, with much larger sums being spent at Christmas than in previous years.

In agreeing with Sir Martin Jacomb's comments, Sir Roland Smith confirmed that retail sales were very much value driven. Although some companies were now taking on staff, there had been a significant increase in the sales of computer systems, where prices were greatly reduced. This suggested that the shake-out of labour was likely to continue, particularly in financial services. He also noted that there was considerable activity among headhunters at middle management level, which could begin to drive up salaries for selected individuals and have a corrosive effect on pay more generally. Sir David Scholey noted that further evidence of the expectations of consumers was that holiday bookings for 1994 generally were going very strongly at the present time.

Sir Colin Corness said that in the construction industry, he had to report that the outlook was still very flat. Although there had been a rise in private housing in 1993 and an increase in employment across the industry, the improvement in private sector housing would be offset by a fall in the public sector. Employment was expected to increase overall, despite a cutback in the road building programme which was less labour intensive. The house price index for the year as a whole had shown that prices had risen by 3% and were likely to rise further. However, he felt that the announcement of the tax measures had made the public rather cautious. Sir Colin confirmed Sir Roland's observation that there was a general increase in automation in the financial services sector, which was having an adverse impact on employment: witness the recent announcements from National Westminster and Barclays Banks of planned reductions of staff. Sir Colin said that Nationwide Building Society had lost 1,600 jobs in 1993, and the cutback was continuing.

Sir David Lees confirmed that output had been stronger in December but the weak position on the continent was having its impact on margins. On the pay front, he felt that there could be increased pressures when the tax increases came into effect in the Spring.

In summing up the discussion, the Governor said that it had illustrated the value of the input from Court, with their individual contributions from different sectors of the economy.

At the Governor's invitation and with the agreement of Members of Court, Mr Beverly, Head of the Financial Markets and Institutions Division, [redacted] attended for the discussion of the paper "Financial Structure: Current issues in three important City markets".

By way of introduction, Mr Kent said that Court would have an opportunity of discussing the Bank's third core purpose later that month. In the meantime the paper before Court covered some of the issues that were of current concern to FMID.

In introducing the discussion on Lloyd's of London, [redacted] said it might be helpful to bring Members of Court up to date with the changes that had occurred since Christmas. At the end of the year, Lloyd's had confirmed that corporate capital would add £1.6 bn extra capacity to Lloyd's, increasing the capacity overall for 1994 to £10.5 bn. Lloyd's had also extended the deadline on the settlement offer following some recalculations just before Christmas. She noted that the press that morning had suggested that voting on the settlement would be a close run thing. Finally, [redacted] said that, on future profitability and solvency, the paper had suggested losses at £1.5 - £2 bn. Recent discussions with Lloyd's had suggested that the figure would be at the upper end of the range and that, without acceptance of the settlement offer, ability to meet solvency in August could be very borderline.

Sir Martin Jacomb opened the discussion by declaring his interest as a Name at Lloyd's. He expressed the view that it was difficult to see how the settlement offer could succeed, having been pitched at such a low level. If Lloyd's did come through the settlement, the question arose of whether it would be able to reduce costs enough to regain its competitive edge and reputation. Lloyd's survival was crucial to the UK insurance market, as Lloyd's reputation was the main reason why insurance business came to London in the first place. Any fall in capacity, as had recently been seen in the reinsurance market with the associated flight of business to other centres such as Bermuda, would undoubtedly lead to business moving away from London. Sir David Scholey expressed no surprise at the recent discouraging news on the settlement offer. He now expected it to be rejected by the Names, who were deeply disillusioned with Lloyd's. He raised the question of what HM Treasury and the DTI might be expecting of the Bank if such a situation was reached. On Sir Jeremy Morse's behalf, Mr Kent passed on comments on the paper: Sir Jeremy now rated the chance of a settlement offer as 50:50, but also perceived a more fundamental change in psychology at Lloyd's towards a more positive frame of mind, which he felt might now be somewhat premature. He had not been as pessimistic as Sir Martin on the impact that meltdown might have on the City, feeling that in the main, the talent would remain in the City outside Lloyd's, although it would be a serious blow.

In responding, Mr Beverly explained that last year the Treasury and the Bank had an uncomfortable sense that the DTI was underestimating the gravity of the situation at Lloyd's. Our own line had always been that no assistance could be expected to come from the Bank. We were holding another meeting with the Treasury and the DTI the following week, to look at Lloyd's position and how it might differ with, or without, a settlement. Some work had already been done by the DTI and ourselves on the implications of a run-off situation; this would be revisited in this context. He reiterated the points made in the introduction that, without a settlement, Lloyd's could face big difficulties in meeting solvency in August. He forecast that losses would certainly be at the upper end of the £1.5-£2bn range and could be a lot worse. Although the problem would lie on our doorstep, we would continue to encourage the Treasury to press the DTI to consider the implications. The Governor concluded that we had been actively persuading the DTI and the Treasury to follow the Lloyd's situation closely, but we felt that in the event of a crisis it was likely they would look to us for advice. Mr Kent explained that any discussion of the question of any assistance to Lloyd's had to be kept extremely confidential, particularly to give the settlement any chance of success. However, in our view there was no political appetite within the Treasury for any rescue of Lloyd's. The opportunity had therefore been taken to see if there was any likelihood of a market support package. At present there was no appetite amongst the large insurance companies to give any support to Lloyd's, although there was always the possibility that a crisis would alter this perception. Sir Martin Jacomb agreed with Mr Kent's assumption that there was no appetite politically or from the other insurers to support Lloyd's at the moment. This, however, could be explained by the very difficult times the companies themselves had experienced recently and the pressures on their own solvency margins. He felt it would be deeply ironic if, at a time when there had been a clear demonstration from corporate investors that Lloyd's had a chance of future profitability, we were unable to find a way of helping Lloyd's through this current crisis.

The Governor explained that there were really only three main sources of funds: the insurance industry; the City more generally; and the taxpayer. He asked the non-City Members to comment on using taxpayers' money for this purpose.
Sir Roland Smith was unequivocal in his view that this was not a viable proposition in the current political climate. On the detail in the paper, he asked about the impact that run-off might have on the banking sector and the background to the assertion in the paper that individual banking supervisors did not feel that any bank's continued viability was threatened by its exposure to Lloyd's. Mr Quinn responded, suggesting that in the context of the discussion and the current uncertainties at Lloyd's it might be timely for the supervisors to examine again the exposures of their individual banks. The difficulty

lay in the absence of discrete statistical information on exposure of the banks to the various sectors of the insurance industry. However, the information we did have from the banks was consistent with the view in the paper that there was no systemic risk to the banking sector. The only exception to this might be in a couple of individual cases which were very reliant on transacting individual business for Names, in which case it would depend entirely on the security Names had provided. Sir David Scholey identified a tertiary pressure on the banking system which could emerge if no settlement was reached, confidence was shaken, and the prospect of a run-off situation looked increasingly likely. This could lead to a lengthening of the claims process as underwriters retained funds, leading to possible liquidity difficulties for the claimants. The Governor concluded that in terms of the banking system as a whole, the exposure of £2.5bn did not look unsupportable, and any risk of a systemic effect looked unlikely.

Sir Roland Smith asked how the crisis might actually arise if there was no settlement, and what impact this might have on the £1.6bn of capacity provided by corporate capital. Mr Beverly confirmed that the corporate capital capacity would remain for the 1994 underwriting year and, leaving aside the settlement offer, the next crisis point would be the reporting of the losses at the AGM in May, and critically, their ability to pass solvency at end August. If, however, the settlement offer was rejected, the situation could escalate rapidly if Lloyd's senior managers chose to consider their own positions. Mr Kent explained that in that situation, a very serious question would arise over who might be able to manage the ensuing chaos if the existing management departed. Sir Colin Southgate expressed amazement that the insurance industry had shown no sign of wanting to help Lloyd's out of its current plight, which he felt could have catastrophic implications for the country, the City and invisible earnings. He agreed, however, that if Lloyd's were to go into run-off it was entirely appropriate for Names to be pursued through the Courts to the full extent of the unlimited liability to which they were committed. However, he wondered if there was not some way of the insurance industry collectively underwriting some assistance to Lloyd's to help it through this cash flow problem.

Mr Laird accepted that a run-off situation would be disastrous, but he had little sympathy for Names and for any move to help Lloyd's with taxpayers' money. Drawing on his own experience as a director of an insurance company, he wondered to what extent the large companies had seriously considered the implications of Lloyd's run-off for the insurance market as a whole. In such a situation, consideration should be given to who might be the main players and who might co-ordinate such a discussion. Mr Kent explained that his assertion that there was no appetite amongst insurance companies had come from a confidential enquiry to the Chairman of the ABI, who had taken the opportunity of sounding out the issue anonymously among a group of chairmen of insurance companies. Whilst information gleaned in this way could not be regarded as entirely reliable, owing to the current sensitivities we currently had no other sources. Sir Roland Smith felt it would be completely unacceptable to policyholders and shareholders of insurance companies to use company funds to help Lloyd's.

Sir David Scholey picked up on the comment from a number of Members that a run-off situation at Lloyd's would be absolutely catastrophic for the City and the UK insurance industry. He did not think it would be so disastrous; in his view, 75% of the damage to Lloyd's reputation and the reputation of insurance in the City more generally had already been done. If run-off ensued, he felt it was likely that the ABI would encourage its members to come in to bolster capacity and ensure that international insurance business remained in London. The Governor confirmed that Sir Jeremy Morse had also been of the opinion that if Lloyd's did enter run-off, business would move elsewhere in London and not necessarily outside. Mrs Heaton agreed that it was important to try and quantify whether run-off would be a disaster. She saw a tension for the insurance industry who, as Lloyd's competitors, might also see some advantage in Lloyd's ceasing to underwrite new business. She felt the strategy of urging the Treasury and the DTI to focus closely on the issue of th2e implications of run-off was entirely correct. There might come a time when the Bank's role would have to change and bring together the interests of the various groups that might be affected by a run-off. At the moment, however, it would be inappropriate to do this.

The Governor thanked the Members of Court for an interesting discussion. The Bank would obviously continue to keep close to developments at Lloyd's over the next few months. He proposed that the discussion on the other topics contained in the paper - LIFFE and a replacement for the Unlisted Securities Market - be deferred until a later date.

Rupert Pennant-Rea

G. A. Croughton.
Secretary.
27 January 1994.

A MEETING OF DIRECTORS AT THE BANK

THURSDAY 20 JANUARY 1994

Present

Edward Alan John George, Esq, Governor
Rupert Lascelles Pennant-Rea, Esq, Deputy Governor
Anthony Laurie Coleby, Esq
Pendarell Hugh Kent, Esq
Brian Quinn, Esq

Hugh Christopher Emlyn Harris, Esq

The number of Directors assembled being insufficient to form a quorum, those present proceeded to the business, subject to ratification by the next Court.

The Minutes of the last Court, having been circulated, were approved.

There being no comments on the weekly figures, Mr Coleby spoke about the foreign exchanges and the state of the domestic markets.

Rupert Pennant-Rea

G. A. Croughton.
Secretary. 27 Jany 1994

A COURT OF DIRECTORS AT THE BANK

THURSDAY 27 JANUARY 1994

Present

Edward Alan John George, Esq, Governor
Rupert Lascelles Pennant-Rea, Esq, Deputy Governor
Sir George Adrian Hayhurst Cadbury
Anthony Laurie Coleby, Esq
Mrs Frances Anne Heaton
Sir Christopher Anthony Hogg
Sir Martin Wakefield Jacomb
Pendarell Hugh Kent, Esq
Sir John Chippendale Lindley Keswick
Mervyn Allister King, Esq
Gavin Harry Laird, Esq, CBE
Sir David Bryan Lees
Sir Christopher Jeremy Morse, KCMG
Brian Quinn, Esq
Sir David Gerald Scholey, CBE

Hugh Christopher Emlyn Harris, Esq
Ian Plenderleith, Esq

The Minutes of the Court of 13 January were confirmed and those of the Meeting of 20 January, having been circulated, were approved.

There being no comments on the weekly figures, Mr Coleby spoke about the foreign exchanges and the state of the domestic markets.

6 At the Governor's invitation, and with the agreement of Members of Court, Mr Beverly, the Head of the Financial Markets and

Institutions Division, and Mr Smith, the Head of the Industrial Finance Division, attended Court for the following discussion.

With reference to a Minute of 16 December, Mr Kent introduced his paper setting out the philosophy behind the Third Core Purpose. This was currently described in the paper as "Promotion of the efficiency of the UK financial services sector, both to meet the needs of the economy and as a valuable contributor to national income, whether generated in this country or by British firms abroad. This we seek to achieve by improving mutual understanding between the financial sector and the rest of business; by facilitating competition among financial intermediaries; by acting as a catalyst to collective action where market forces are judged to be deficient; through advice to Government; through our expertise in the market place; and by supporting British interests through our relationships with financial authorities overseas".

Mr Kent said that the Third Core Purpose was one that had a long history, as evidenced by the extracts from the MacMillan, Radcliffe, Wilson and CBI reports, going back over some 60 years. In one aspect or another, it was about the relationships between the City and industry. The demand for the Bank's involvement in this function came from both sources and sometimes from Whitehall, and was more appreciated outside the Bank than within. The success of the Bank's involvement was based on our knowledge of the City and of the players in it. It did not consume many resources and was, in practice, a function owned by the whole Bank, not just the two Divisions concerned. It was important to the achievement of the Bank's first two core purposes that we should demonstrate our interest and care in the welfare of the economy as a whole. In this sense the Agents fulfilled an important role, providing a tangible sign of our concern for the whole country and not just the City, and acting as ambassadors and listening posts. It would be inefficient not to have someone fulfilling the Bank's Third Core Purpose role and, if the Bank did not do it, others would. Sir Colin Southgate, who was unable to be present that day, had suggested that the difficulty in accepting this function as a third core purpose might be its label. Leadership and the conflict solving roles fell naturally to major institutions, but they were not core: more a natural corollary to a core purpose.

Sir Christopher Hogg said he had sympathy with Sir Colin Southgate's view. It was overblown and misleading to call this role a core purpose. He felt it was a secondary role of maintenance, requiring resources which could react - as they already did in a pretty effective way - to a range of situations. However, it implied the need for total commitment, and he was not sure that the Bank was properly equipped to do that. Sir Chips Keswick disagreed with this analysis; he regarded the Third Core Purpose as co-equal with the other two. The City was divorced from the domestic economy but provided considerable prosperity for the rest of the UK, and it was of critical importance to be sure that the integrity of the City was preserved at all times. The Bank was in a unique position to do this. In declaring himself to be closer to Sir Chips's view than Sir Christopher's, Sir Jeremy Morse recognised the importance of the Bank being thoroughly well informed on what was going on in the City. He saw this as vital to the country, and indeed vital in terms of keeping the City's pre-eminence. The important thing was that the Bank, which is viewed as a pater familias for the City, was fully informed and could be thinking ahead. He was reasonably happy with the scope of the Third Core Purpose and saw it as a reflection of the need for greater co-ordination in the City. Mrs Heaton agreed with Sir Jeremy's comments. She felt that the Bank's role was valued by the community, and was also particularly useful to Government in that it removed some of the heat from them. If there was a disadvantage, it was that the City became distanced from Government.

Sir David Lees commented that he felt this core purpose was some way behind the first two, and asked to what extent the views expressed in the paper had been discussed with Government, the Bank's shareholder. Were they comfortable with the present situation and did they wish the Bank to carry on doing these various functions which, he acknowledged, the Bank fulfilled very effectively? In response, Mr Kent drew attention to a number of examples - the London Approach, small companies, Canary Wharf and the Jubilee line extension, and Eurotunnel - where the Bank's involvement had been either with the blessing or, less frequently, at the initiative of Government departments. Overall he suggested that Government had been understanding, supportive, and encouraging towards the Bank in these issues. In commenting on this point, the Governor said that the initiative for the Bank to become involved in such issues was usually taken by a third party, whereas we used our own initiative in becoming involved in market related issues concerning our first and second core purposes.

In commenting on the paper, Sir Martin Jacomb felt that there should be a distinct separation between the Bank's involvement in the UK, and the Bank's involvement in an international dimension, which had no direct relationship with the UK economy. In agreeing with Sir Jeremy Morse, Mr Laird felt instinctively that the Bank had to be knowledgeable about what was going on and that the Agents had an important role to play in this. However, he questioned whether the Bank conferred sufficient authority and resources on them to perform their role effectively.

Sir David Scholey agreed with Sir Christopher Hogg that the function was overblown and misleading. He drew a distinction between the perception of the Bank's role in the City and that held in the rest of the economy. He questioned where the authority and influence of the Bank should rest, and said that there was a great problem in taking on issues without having the authority to see them through to the end. In focusing on the promotion of the City, for example, Sir David said that not only was the Bank involved but Government and others as well. There was a need for a clear definition of responsibilities - and not an assumption that the Bank would be involved.
Sir David also identified the equity markets as another area

where the Bank could be more proactive, and indeed, could be vulnerable to criticism for not being more so.

Mr Plenderleith felt that there was a legitimate role for the Bank in the Third Core Purpose, in that it had direct linkages to the First and Second Core Purposes of monetary and financial stability. However, he suggested that the Bank should be selective in what it did under the Third Core Purpose. He was generally comfortable with the criteria set out in Mr Kent's note, but agreed with Sir Christopher Hogg that the Bank's involvement should be low profile.

Mr Quinn said that his view was now close to that expressed by Mr Plenderleith. Reverting to the discussions that had taken place at Ashridge, he said that he recognised that certain elements of the Third Core Purpose fitted in with the two wings on monetary and financial stability which had emerged from the Executive's discussions. He felt that the criteria for carrying out the role should be rigorous and that a distinction should be drawn between the reactive and proactive approach.

In summary, the Governor felt that the broad thrust of the discussion had indicated that we should continue to carry out the roles of the Third Core Purpose, even those in the outer rings, such as the linkage with industry. This conclusion was despite the fact not all of the roles fitted neatly under the umbrella of the monetary stability or financial stability wings. However, he was not certain about the Bank's involvement with some of the financial markets, such as the equity and insurance markets, though he felt that the principle of free markets should be allowed to remain. Sir David Scholey said that whilst he understood the Governor's comment about the equity markets, he questioned whether it was at odds with the Bank's core purpose to promote effective financial markets.

Finally, the Governor said that he had found the discussion very helpful. However, he felt that it was necessary to be more specific in the description of the Third Core Purpose and suggested that a revised form of wording might be brought back to Court in due course. He reminded Members that the document setting out the Bank's core purposes was in fact an internal document and only for our own guidance.

[redacted] [redacted] [redacted], attended Court for the discussion of the draft Inflation Report, which was due to be published on 8 February.

In introducing the draft of the February Inflation Report, Mr King noted that it was longer and more technical than the final published version would be. There was a trade-off between offering Court a more polished, readable draft and presenting a version early enough to take on board any comments Members wished to make.

The judgement about the direction of underlying inflation was still clear, despite the fact that the last Report's short-term projection had proved too high. A lot of the factors which made it difficult to draw up accurate short-term projections were transitory, cancelling each other out in the longer run. The major points to consider this time were, first, monetary growth rates had increased significantly, and secondly, total output now appeared to be increasing at about 2 1/2% per annum, with non-oil output increasing at 2% per annum, and manufacturing output at 2 1/2 - 3% per annum. The most recent figures for manufacturing growth were no longer distorted by the problem of measuring export prices properly. Thirdly, there was considerable uncertainty about what was happening to the output gap. Output growth seemed to be inadequate to close it, yet capacity utilisation had increased and unemployment had fallen more than expected. Finally, wage settlements were running at the lowest rates in memory, but it was uncertain how they would respond to the tax increases arriving in April.

The Bank's central projection for inflation, measured by the RPI excluding mortgage interest payment (RPIX), is for a slight increase as the result of the prospective increases in indirect taxes. According to the Bank's measure which excludes these taxes (named RPIY), inflation is likely to remain flat at around 2 1/2% per annum for the next two years. The main risks would be, first, that the prospective tax increases would depress activity by more than estimated; secondly, that the economy was closer to full capacity than the projection assumed; and thirdly, that wage settlements would increase more in response to tax increases. The first risk would imply lower inflation than projected, the second and third, higher. But at low inflation rates, the overall risk was likely to be asymmetric, because general price reductions were improbable.

Under the weekly executive report:-

1 Mr Harris reminded Court that on 16 December the Governor had briefed Members on the outcome of the Executive's discussions at Ashridge earlier that month. In particular, he had spoken about proposed changes in the management of Officials and mentioned the establishment, under the Deputy Governor, of a Working Party to take the ideas forward.

The first priority for the Working Party had been to consider the terms of the imminent annual performance review in the light of the Ashridge objectives. Recognising that not everything could be achieved in the short term, the Working Party had proposed that it would be feasible to:-

(i) combine the two amounts of money (the so-called pots) available to the two groups of officials (analysts and managers) for performance awards;

(ii) skew the rewards towards the better performers at analyst level, where we had the greatest problem in retaining good staff; and

(iii) combine the performance award with any "across-the-board" award, so that, in future years, staff would receive one annual award in March, rather than two, in March and July.

The first and third objectives would require negotiation with BIFU. But before entering into discussions with them, Mr Harris sought Court's agreement to the third element, which would entail paying this group of staff an across-the-board award eight months after the previous one.

The Bank were, of course, sensitive to the public sector pay policy, and had already told the staff that we would certainly comply with any requirements on pay laid down by the Government. This was being interpreted as a flat position in the cost of pay and overtime in the Bank-wide budget for 1994/95 compared with the budgeted figure for 1993/94, which might allow for an average increase up to a maximum of 2.5%.

Mr Harris said that the Deputy Governor had raised the question of a March settlement date for Officials with Sir Terry Burns, who had responded saying that he recognised the importance attached to making these changes in 1994 and, in the circumstances, would not stand in our way. It would be essential however that we were ready and able to show that the change was a technical one which did not weaken the Government's general posture. The key to this would be that we could show that the across-the-board rise in March was smaller than it would have been in July, reflecting the shorter pay cycle, and that staff would not receive any more in 1994/95 than they would have done under the previous arrangements.

Court were content that Mr Harris should enter into negotiations for Officials on the basis he had described.

2 The Governor said that copies of the Minutes of evidence to the TCSC on the role of the Bank were available to Members of Court on request; and that the Budgen Bill would receive a second reading in the House of Commons the following day, Friday 28 January.

Adrian Cadbury
3rd Feb 1994.

G. A. Croughton.
Secretary 3rd Feby 1994

A COURT OF DIRECTORS AT THE BANK

THURSDAY 3 FEBRUARY 1994

Present

Edward Alan John George, Esq, Governor
Sir George Adrian Hayhurst Cadbury
Sir Colin Ross Corness
Mrs Frances Anne Heaton
Sir Christopher Anthony Hogg
Sir Martin Wakefield Jacomb
Pendarell Hugh Kent, Esq
Sir John Chippendale Lindley Keswick
Mervyn Allister King, Esq
Sir Christopher Jeremy Morse, KCMG
Sir David Gerald Scholey, CBE
Professor Sir Roland Smith

Hugh Christopher Emlyn Harris, Esq
Ian Plenderleith, Esq

The Minutes of the last Court, having been circulated, were approved.

At the Governor's invitation, Mr Footman, the Head of Information Division attended Court to speak about the work of his Division, together with Sir Peter Petrie, who was involved in developing a closer liaison between the Bank and Parliament.

Mr Footman said that the Bank's day-to-day relations with the press were currently fairly straightforward dealing principally with issues relating to the economy, interest rates and "independence". The Bank's Tercentenary was also a matter of some interest to the press. Their interest will grow later in the year as events take place, particularly the issue of the £2 coin and the £50 note. So far as the Division as a whole was concerned, Mr Footman said that they had been concentrating on communications within the Bank particularly in speeding up notification to the staff about interest rate changes, and in the circulation of copies of the Governors' speeches etc.

One new venture was the planned introduction of a staff newspaper. A number of trial editions had been made available on a limited circulation basis, and the go-ahead had now been given for the paper to be produced fortnightly, starting next month. The paper would be unambitious in appearance, following the small tabloid layout rather than a glossy magazine format, and would focus on the Bank's role as a central bank and as an employer. It would be very much up to date, with printing on Wednesday evening for circulation the following morning.

Mr Footman reminded Members that when he had spoken to Court previously, he had outlined plans to streamline the Bank's response to incoming mail, particularly complaints. He was now able to report that this was working well, the response time had been cut back and the Bank had even received letters of thanks and congratulations on its efficient response to correspondence.

In speaking about his role, Sir Peter Petrie said that unlike the Foreign Office that had the advantage of ready-made contacts with Parliament through Ministers and Parliamentary Secretaries, the Bank had to take the initiative in establishing these relationships; this was being achieved by inviting MPs, particularly members of Backbench Committees, to the Bank to meet the Governors, Directors and those involved in various aspects of policy. A number of seminars had been held in the Bank and, to date, some 100 MPs from the Government side, 30 Labour MPs and 6 Liberals had attended. Feedback generally was very favourable, and it was proposed to continue with this formula, in particular in targeting Labour MPs in future.

In response to Mrs Heaton's enquiry about communications with other members of Government below Cabinet level, Sir Peter said that there was regular contact with Parliamentary Private Secretaries, and Ministers during the normal course of business and at social events, etc. including dinners arranged by the Governor, specifically to meet this need.

Referring to the proposed staff newspaper, Sir Christopher Hogg said that he hoped very much that this would be made available to Members of Court. Sir Adrian Cadbury commented that, from his experience, a newspaper would attract greater interest among the staff, compared with a glossy magazine, such as 'The Old Lady', which tended to be of greater appeal to pensioners. Such a publication would, of course, carry risks - the national and local press would be keen to scan its pages - but at the same time it would present useful communication opportunities. In supporting the introduction of a staff newspaper, Sir Jeremy Morse said that a similar decision had been taken at Lloyds Bank. He recalled that their glossy magazine, 'The Black Horse', the equivalent to 'The Old Lady', was seen as a staff publication whereas, the newspaper was regarded more as a management tool. From this experience he advised the Bank to be open and frank in dealing with management issues in the newspaper. Turning to other issues, Sir Jeremy Morse said that in the context of the Bank's Tercentenary he thought it was very important to ensure that the exhibition "From a National to a Central Bank" which would take place towards the end of the Bank's celebrations was successful. It was an important opportunity for promoting the Bank, particularly at the present time when so much interest was being shown in the "independence" issue. On that subject he enquired whether it was appropriate to talk about "independence" for the Bank? In response, the Governor said that we had tried to move away from that description by talking about "accountability" and he endorsed Sir David Scholey's suggestion that "independent accountability" was perhaps an even more appropriate description.

In response to Sir David Scholey's questions about 'The Old Lady', Mr Footman explained that publication would continue for the time being, and that the staff newspaper would also be made available for pensioners to purchase, on the same basis as currently for 'The Old Lady'. Mr Footman endorsed Sir David's view that the Bank Museum was a very valuable information source and was one that the Information Division used continuously both as an outlet for books on the Bank, etc, and other educational material; and for arranging talks and films on the Bank's role in the Museum cinema. He confirmed that he was very much involved in influencing the educational output of the Museum but was less involved in the displays, which was the responsibility of the Curator.

In thanking Mr Footman for his presentation, the Governor said that the Information Division was doing a splendid job.

There being no comments on the weekly figures, Mr Plenderleith spoke about the foreign exchanges and the state of the domestic markets. Details of the Official Reserves figures for January were in Members' folders.

At the Governor's invitation and with the agreement of Members of Court, Mr Beverly, Head of the Financial Markets and Institutions Division, together with [redacted] attended for the continuation of the discussion of the paper "Financial Structure: Current issues in three important City markets".

In introducing the item on LIFFE, [redacted] said that LIFFE had been, and continued to be, one of the City's most successful institutions. Nevertheless, as the paper pointed out, the exchange faced a challenging future and some potential threats.

LIFFE was about to lock horns with OMLX, a London based subsidiary of a Swedish futures exchange. Later this month LIFFE was to launch a future contract on the FTSE 250 index to compete directly with similar OMLX contracts which would start trading the following day. The battle would be an interesting one and provides an illustration of some of the concerns expressed in the paper. The threat of screen-based trading to LIFFE's floor-based market; the possible isolation of LIFFE in the face of European alliances; and the nimbleness required to form a successful strategy to see off the competition.

Competition was not just at home, of course. LIFFE was the leading European futures exchange and, with its wide international product range, was there to be shot at by overseas markets wishing to repatriate business based on their domestic instruments. Competition, particularly from the DTB, was likely to intensify over the short to medium term. There were also signs that an alliance of Continental exchanges, possibly grouped around the DTB/MATIF, may be forming to combat LIFFE's current dominance.

Looking further ahead, LIFFE had to consider the impact of EMU and whether the loss of European currencies implied that it should take steps to reduce its reliance on DM products. The exchange was already looking to list a Euroyen contract.

LIFFE faced a range of real and potential threats - strategic, technological and political. It was facing up to the challenge. The role of the authorities was to ensure it could do so on a level footing.

Having declared his interest as Chairman of Reuters, co-owners of GLOBEX, the screen-based system which LIFFE were currently negotiating to join, Sir Christopher Hogg said that, in his experience, the democratic nature of exchanges led to slow decision-making, dominated by parochial and short-term interests. He held up MATIF as the exception to this rule and called for LIFFE to take a similarly positive attitude to joining GLOBEX, as had the French exchange. Sir David Scholey also felt that UK exchanges tended to take too insular a view, being slow to respond to external events. He suggested that LIFFE should seek to integrate itself more fully into Europe, particularly with moves towards monetary union. It should

seek to broaden its product base over the next ten years so as to prepare for EMU. Mr Plenderleith responded that LIFFE's success across a range of international products, and in the face of strong competition from the DTB, was clear evidence of good management and careful strategic planning.
Sir Jeremy Morse pointed out that EMU would not happen overnight and that LIFFE would be able to react as the transition took shape. Mr Kent said that if the Stock Exchange forged alliances in Europe this would provide opportunities for the derivatives market.

Sir Martin Jacomb felt that LIFFE was a successful market because the exchange understood and responded to the demands of users and had experienced practitioners amongst its management. Its record in the face of competition from the DTB was remarkable given the support for the DTB from the German authorities and major banks. He thought that LIFFE's decision on membership of GLOBEX was difficult as the benefits were not clear cut. Sir Christopher Hogg agreed that LIFFE's decision was a difficult one but argued that it should follow the MATIF's more enthusiastic approach or risk being left behind. The Governor responded that, while not being grounds for complacency, the reason for the different approach may be that LIFFE had more to lose than MATIF which was negotiating from a weaker position.

After a few introductory remarks by [redacted] to bring Members of Court up-to-date with the action taken by the Stock Exchange in relation to a replacement for the Unlisted Securities Market, Sir Christopher Hogg suggested that a regulatory problem almost certainly arose if there were two separate markets. In his view, it would be undesirable to have a separate market with higher risk - regulation would always be necessary and he therefore had some sympathy with the Stock Exchange's view that it was very hard to make an adequate distinction.

The Governor wondered how possible in practice it would be to have a separate market. [redacted] replied that there were at least two constraints in this area. The first was that there were minimum European requirements - given by the Prospectus Directive for example. Secondly, there was also the question of institutional preferences. Whenever we had asked them, the large institutions were quite clear that they needed at least as much - and quite possibly more - information on small companies as on the larger.

Mr Plenderleith agreed that this was the nub of the dilemma. There were certain facts arguing against a second market which it was impossible to ignore but, at the same time, there was a general background of discontent and claims that one had to exist. In Mr Plenderleith's view, although the Stock Exchange had been right in its diagnosis of the continued need for the USM, there had nevertheless been a failure in communications. He felt that the Exchange should now be more pro-active and seize the high ground of the debate. One way of doing this would be to organise a symposium in which the various protagonists could debate the arguments on either side. Another way would be to test demand by the Exchange throwing open its own technical facilities (opening its screens for example) on a caveat emptor unregulated basis. In Sir David Scholey's eyes, however, that would be unlikely to work. Bodies had to take genuine responsibility for an issue if it was going to succeed.

The Governor said that the Exchange was finding it difficult to articulate the case - one in which they strongly believed - against establishing a second market and for providing the facilities needed instead, through the Official List. He and Mr Kent had already spoken to the Chairman of the Exchange in this vein and suggested that he should try hard to make a stronger public case for the quite powerful arguments which could be made against a USM replacement.

Sir Martin Jacomb pointed to a slightly different problem. This was that the modern world expected to see all information on a company made available at the same time. In the old days one broker would have known everything about a small company, including the current pattern of shareholders and where demand was likely to lie if there were sellers. Reconciling this intimate - though arguably inside - information with today's well-regulated markets was very hard.

Mr Kent felt that it was important for the debate not to be conducted simply in terms of supplying equity capital at its cheapest price to small companies. There was an important earlier stage involving venture capitalists, who would not invest in the first place if they were not guaranteed a way of exiting at the right time.

In conclusion, Sir Chips Keswick felt that the Bank should not champion the cause of a replacement for the USM. The Governor agreed with this sentiment but nevertheless felt that the Stock Exchange should be making a more public and a more definitive case along these lines.

Under the weekly executive report, the Governor discussed with Court the names of a number of candidates for appointment as Non-Executive Director.

Rupert Pennant-Rea

G. A. Croughton.
Secretary. 10 February 1994.

A COURT OF DIRECTORS AT THE BANK

THURSDAY 10 FEBRUARY 1994

Present

Edward Alan John George, Esq, Governor
Rupert Lascelles Pennant-Rea, Esq, Deputy Governor
Sir George Adrian Hayhurst Cadbury
Anthony Laurie Coleby, Esq
Sir Colin Ross Corness
Mrs Frances Anne Heaton
Sir Martin Wakefield Jacomb
Pendarell Hugh Kent, Esq
Sir John Chippendale Lindley Keswick
Mervyn Allister King, Esq
Gavin Harry Laird, Esq, CBE
Sir Christopher Jeremy Morse, KCMG
Brian Quinn, Esq
Sir David Gerald Scholey, CBE
Professor Sir Roland Smith
Sir Colin Grieve Southgate

Hugh Christopher Emlyn Harris, Esq
Ian Plenderleith, Esq

The Minutes of the last Court, having been circulated, were approved.

Details of the weekly figures and graphs on the foreign exchanges and the domestic markets were laid before Court. A brief discussion ensued, concerning the reduction in interest rates which had been announced earlier that week.

Under the weekly executive report:-

(i) Mr Kent drew Members' attention to the Private Finance Initiative which had been set up by the Chancellor of the Exchequer as a joint Government and private sector attempt to provide finance for a number of projects, many of which were infrastructure, and particularly transport, related. Sir Alastair Morton had appointed a Private Finance Panel of 15 people from the private sector and from Government. Each of the Government "spending" Departments was represented in this initiative. They had so far identified 89 projects for consideration. Mr Kent had been asked to sit on two sub-groups of the Private Finance Panel. One would consider transport; the other the City Panel, would be interested in the principles of financing projects, rather than the projects themselves. He said that it would take several months for this initiative to make an impact. In the first instance it would be necessary to establish ground rules, but he was confident that the initiative had the full commitment of Government, and the Chancellor of the Exchequer in particular.

In response to Sir Colin Corness's concern that the past record of this sort of initiative had not been good, very largely through inactivity on the part of HM Treasury, Mr Kent said that HM Treasury recognised the need for private capital to be involved in these projects, and, indeed, might be represented on the project groups. However, he accepted Sir Martin Jacomb's comment that the difficulty would be in finding a way of attracting private capital to this venture. He pointed out that it was not the intention to have one pool to finance all projects but that each should be financed separately. In response to Mr Laird's enquiry about European Community constraints requiring projects of this nature to go out to tender, Mr Kent said that he could not answer that question fully at this stage. It was one of the many difficult questions that would have to be faced in the future.

(ii) Mr Kent reminded Court of previous discussions about the flotation of 3i and said that the Bank and the clearing banks, as shareholders, had agreed to move to flotation. An announcement to that effect was likely the following week. The proposal was for an initial flotation of 20% of the capital of 3i, which would produce some £300 mn; the Bank's pro rata share would amount to some £40 mn. If market conditions remained favourable, a larger proportion might be placed. Although discussions continued on a number of issues which still had to be resolved, Mr Kent said that the Bank, as supervisor of 3i, had reviewed the Company's position and had agreed that 3i could retain its two banking licences.

In response to Sir Roland Smith's comment that, in the light of the Bank's current stance in respect of small businesses, etc, the proposal to sell part of its shareholding seemed out of place at the present time, Mr Kent identified three reasons for going ahead with the proposals. 3i was now a successful commercial company in a mature and competitive market, and it was inappropriate for a central bank to be a shareholder in such a company; there was an awkwardness in that the Bank was 3i's supervisor; and, if one accepted that the Bank should disinvest on those grounds, then the timing now was appropriate with the stock market buoyant.

(iii) The Governor said that following recent discussions at Court, arrangements had been made for the non-Bank Members of the Board of Banking Supervision to attend Court on 12 May, when the agenda would be devoted to supervisory matters, including Reports of the Board of Banking Supervision and the Bank's Report under the Banking Act. He suggested that it might be appropriate, on that occasion, for members of the Bank's Executive to withdraw so that Non-Executive Directors

...

could discuss issues freely with Members of the Board of Banking Supervision.

At the Governor's invitation and with the agreement of Members of Court, [redacted], attended Court for the discussion of the Reports of the Securities Committee, and the Trustees of the Court Pension Scheme, together with two papers from the Chairman of the Trustees of the Staff Pension Fund.

Sir Martin Jacomb, in his capacity as Chairman of the Securities Committee, spoke about the Reports of the Chief Investment Manager and the Pension Fund's investments and investment policy during the six months from 1 April to 30 September 1993. He said that the overall investment performance of the Fund had been very good in 1993, with early indications that the return, as measured against the WM Performance Index, was 38.1% against an average of 27.7%.

In response to a question from Sir David Scholey, Sir Martin Jacomb said that the comparison was against pension funds of comparable size in the WM Survey. No comparative figures with mature funds were available. Sir Martin Jacomb drew attention to the risk of volatility in the Bank's contribution rate following the adoption of "Basis C" assumptions for the Staff Pension Fund valuation as at 28 February 1993, which assumed that a high percentage of the Fund's investments would be held in equities. The Report was laid before Court.

The Governor, having declared his potential interest in the Court Pension Scheme, together with those of the Deputy Governor, Messrs Quinn, Coleby, King and Kent, invited Sir Adrian Cadbury, the Chairman of the Trustees of the Court Pension Scheme, to introduce a Report of the Trustees.

Sir Adrian said that as a number of pension issues had arisen which were very much linked to remuneration in its widest sense, the Trustees had recommended to the Governors that there should be some cross-membership of the Trustees with the Remuneration Committee.

Referring to the question of the merger of the Court Scheme and Staff Pension Fund, which had been raised at an earlier Court by Sir Colin Southgate, Sir Adrian said that the Trustees had considered that there were a number of practical reasons for keeping separate schemes, for example, the different accrual rates. But he acknowledged that much of the administration of the Staff Pension Fund and the Court Pension Scheme had been, and should continue to be, brought into line.

Mr Harris presented a paper on the governance of the Staff Pension Fund. It contained two recommendations concerning the composition of the board of Trustees and the responsibility for investment strategy. He said that Messrs Coopers & Lybrand, in their last two management letters following their annual audits of the Pension Fund, had drawn attention to the fact that current practice in these areas did not accord with accepted best practice, which had been confirmed by the Report of the Goode Committee. However, the Executive, having considered the question of representatives of the active membership, had decided to await the final outcome of the Goode Report before making any changes, as it was by no means certain that the Committee's proposals would remain in their present form. Rather than set up a new structure that may be inappropriate, and as neither the members nor the Unions had asked for representation at this stage, it was considered unnecessary to make changes now. On the question of the responsibility for investment strategy of the Fund, Mr Harris said that the proposals would merely transfer the responsibility from the Securities Committee to a revised Board of the Trustees of the Staff Pension Fund: this had the agreement of both parties, although the Executive was not unanimous on this issue. The proposal to disband the Securities Committee had implications for the smaller funds detailed in the Report, whose trustees were not yet aware of the proposal.

Mr Laird sought assurance that investment strategy would remain under the control of Court. Mr Harris said that this could be the case. The Governor said that whilst it was proper for beneficiaries to be concerned about the security of the Fund's assets and the ability of the Fund to pay the benefits due, he did not consider it appropriate for them to be involved in the investment policy, particularly as the Bank guaranteed the Fund. The Governor felt that any decision should await the final outcome of the Goode Committee's proposals. In further discussion, Members of Court drew attention to various practices and experiences in their own pension funds and those with which they were associated, particularly so far as the appointment of Trustees was concerned. The Governor concluded that the general view was that no change should be made at this stage to the composition of the Trustees on account of members' representation, but that there was support for transferring the investment strategy responsibility to a revised Board of Trustees on the understanding that any significant change to investment strategy would be agreed by Court, to whom periodic reports on the investment of the Fund would be submitted. The recommendations were approved.

In conclusion, and in standing down the Securities Committee, the Governor thanked the Members of the Committee and the Trustees of both Pension Funds for their contributions.

Mr Harris, in his capacity as Chairman of the Trustees of the Staff Pension Fund, presented a Report on the Valuation of the Fund as at 28 February 1993. He drew attention to the assumptions adopted for the valuation. They required a future annual contribution rate of 19.5% of pensionable remuneration; but in view of the surplus in the Bank's Accounts (under SSAP 24), a payment of 10% pa only would be paid until the next valuation.

In response to a question from Sir David Scholey, Mr Harris confirmed that both the Trustees and the Securities Committee were aware of the Actuary's views on the implications of the maturity of the Fund for investment strategy.

At the Governor's invitation, and with the agreement of Members of Court, Messrs Foot, [redacted] members of Banking Supervision Division, attended Court for the discussion of a paper 'Banking Supervision Division: International Policy issues'.

In introducing the paper, Mr Quinn explained that it described two different issues which had been chosen to illustrate the range and complexity of the Division's work on international policy issues. The first part of the paper described the work in progress on developing the supervisory framework established by the 1988 Basle Accord. The Accord, in focusing on credit risk, had not captured other aspects of risk run in the banking system, and the recent proposals from Basle were intended to address this unfinished business. The rapid growth in derivative and other trading activities of banks gave the proposals particular relevance.

Mr Quinn noted that developing the framework to capture market risks was technically complex in itself, but there were two additional complications. One was that the G10 treatment had to fit in with the EU's Capital Adequacy Directive (which also dealt with market risk). The other was that it had to take account of similar proposals being discussed amongst securities supervisors in the IOSCO forum. Ideally, the rules eventually agreed should bear a close resemblance - or be identical, if possible - but this would be difficult to achieve. The G10 membership was different from the EU's, and the European Commission was anyway not likely to be flexible about re-opening a directive which had already been agreed. The Bank also had to keep an eye on the views of other UK authorities, notably the SIB and HM Treasury, and thus to try to ensure that the various agendas - domestic and international - converged.

The second part of the paper illustrated a different, but equally challenging, question. The BCCI experience had demonstrated that there were limits on the extent to which depositors in branches of foreign banks could be safeguarded by the efforts of the host supervisor. But at the same time legal advice which we had received in the course of post-BCCI analysis overturned a fundamental assumption underlying our supervision of overseas branches. This was that we were able to rely on the assurances from home supervisors in the course of our on-going supervision. We were also conscious of the general heightening of expectations regarding supervisory standards, meaning that supervision now had to meet a more demanding test of acceptability.

The description in the paper of the problems with the Iranian branches demonstrated the practical difficulties of operating against this background. It illustrated the need for supervisors to look beyond the institutional to the macro-economic conditions in a country. But there were other examples - for instance, Chinese banks which wished to branch into London, or Japanese banks where we did not feel we knew enough about the strengths of the supervisory agencies.

In summary, the paper drew attention to the different challenges - technical and diplomatic - the banking supervisors had to meet, and the range of vision they had to adopt whilst keeping a firm eye on their primary responsibility towards depositors.

In commenting on the first part of the paper, Sir Jeremy Morse noted the importance of ensuring that the approach eventually adopted was not a narrowly European one. He asked whether the Bank was managing to win the argument on this front. Mr Smout said that, as far as progress with the non-European securities supervisors was concerned, this had been disappointing. However, issuing the papers without waiting for the agreement of the securities supervisors had been the right decision, since they had stimulated a more public debate. Attempts were being made to keep up the dialogue with the securities supervisors, principally in the area of derivatives. Mr Quinn noted here that the securities supervisors did not themselves have a uniform outlook, and in particular the SEC's views tended to diverge from those of other securities regulators.

Concerning the more general point of whether the Europeans could be persuaded to adapt their framework to accommodate other countries' views, Mr Foot was pessimistic; it was likely to be very difficult to get the CAD changed, and the lack of flexibility being shown was a worry to us.

Sir David Scholey asked whether the Bank was uncomfortable with the prospect of possible increased disintermediation as a result of the new capital adequacy requirements, as referred to in the paper. Mr Foot said not; we were happy with a diversity of financing opportunities, and had no worries on behalf of professional investors. [redacted] emphasised that while the capital requirements might act to accelerate the disintermediation trend, the trend had to be attributed to other causes as well.

Turning to the issue of overseas branch supervision, the Governor noted that this was an immediate anxiety to the Bank. The legal advice received, if taken literally, would imply a radical shift in the way we supervised such branches. HM Treasury's attitude, which stemmed from a fear that a change in the legislation would be seen in Parliament as a relaxation of supervisory standards, had been unhelpful. Our reaction had been to improve our knowledge of overseas supervisors' regimes and competence, so that we could more justifiably rely on them even without an explicit legal right to do so. We were also continuing with efforts either to get the legislation changed or to get a different interpretation of the existing legislation from the Treasury.

Sir Colin Southgate asked for more information about supervision in China. [redacted] explained that the People's Bank of China was the supervisory body. It conducted supervision through regional and local branches, with policy being set from

Beijing. Inspection was geared partly towards compliance with economic policy regulations, for example on directed lending. However, we had found that, at the local level, the supervisors had been aware of prudential considerations also. It was also encouraging that Price Waterhouse had been contracted by the World Bank to do a three year study, aimed at identifying the improvements needed to bring Chinese supervision up to international standards. In this context, [redacted] remarked that the World Bank's technical assistance in places like China and the Indian Subcontinent was not widely known, but we had been impressed with it. However, in China the legal and accounting infrastructure was not yet fully in place, and although the accounting questions were being addressed, the legal questions were not.

[redacted] said that the Bank's response to branch applications from Chinese banks was going to be cautious. We had had a branch of Bank of China in London since 1929, and a number of other Chinese banks had established representative offices over the last 18 months with a view to getting branch status. However, we had told the People's Bank that, prior to the completion and implementation of the Price Waterhouse report, we were unlikely to agree to the establishment of branches, although subsidiaries might be a possibility. The Governor added that we had, however, stopped short of telling Bank of China to incorporate in the UK. Sir Chips Keswick remarked that he doubted that the Chinese supervisors' understanding of prudential considerations extended to an understanding of systemic risk.

Sir David Scholey recalled the delicate diplomatic situation which supervisory difficulties with [redacted] had given rise to, and asked whether the Treasury had considered the implications of this type of situation. He also asked about the extent to which we were exchanging views and information on dubious countries with other 'respectable' supervisors who might have an interest, for example the US and Switzerland.

[redacted] noted that the [redacted] episode had in the event been handled successfully, with a voluntary withdrawal by the bank and smooth cooperation with the Treasury and Foreign Office. He acknowledged, however, that such an outcome could not be guaranteed next time around. With regard to cooperation with other supervisors, he explained that only the US seemed to share our approach of getting to know other supervisory regimes. There was some informal communication with the US supervisors, although it was complicated by the fact that there was more than one agency. He felt that we could not get away from the need to gather sufficient information to make up our own minds on the competence of a particular regime; he pointed out that, even if we did get the legal power to rely on an overseas supervisor, we would want to be able to judge whether we could comfortably do this.

Mr Quinn mentioned that informal communication did take place amongst the G10 supervisors, and the Bank was trying to encourage the same process in Europe. One possibility under discussion was a register, available to all the EU supervisors, of banks which had been refused authorisation by any one supervisor. This would principally be a means of sharing information on particular institutions, but could also lead to dissemination of views on supervisory regimes. Mr Foot added that we were encouraged by the increased attention being given to this question in Europe, partly as a result of the 2BCD passporting provisions. Some countries had concluded that they did not have sufficient powers to refuse licences, which they were looking to remedy.

Mr Laird asked whether, in view of the increasing complexity and internationalism of supervision which had emerged from the paper, the Bank was devoting adequate resources to supervision. The Deputy Governor replied that the fundamental review of the Bank's structure currently underway gave us an opportunity to consider precisely this question. Mr Foot added that it was also a question that was kept in mind as part of the annual budget process. Bearing in mind that we did not have infinite resources, the aim was to allocate them to areas in a way which reflected the degree of risk in each area.

Returning to the question of the Chinese supervisory regime, Sir Martin Jacomb pointed out that, with autocratic governments which had ultimate power, it was important to know their attitude as well as that of the supervisory authorities. He asked whether we had talked to the Chinese government. He also drew attention to the possible distinction, in assessing foreign branches, of systemic risk and risk to individual depositors. He asked whether we felt we could rely more on 'market' supervision if the branches were largely funded by wholesale deposits.

[redacted] replied to the first question that we had talked only to the People's Bank, which was, however, an organ of government. He agreed nevertheless that the autocratic nature of the Chinese government did introduce extra complexities, in that the banking sector was currently being used as an instrument of the Government's wider economic policy. However, the authorities were making efforts to separate out banks' commercial lending from that part of their book which was government-directed, with the aim of subjecting the commercial lending to internationally recognised standards. He also drew attention to another facet of the state's role, which was that the banks showing interest in establishing London branches were the large, state owned banks. This made them less likely to fail. Sir Chips Keswick responded that this was a very dangerous assumption, given that the Chinese government had allowed state-owned industrial companies to fail. [redacted] acknowledged the point, although he suggested that since the banks concerned each accounted for around 20% of the financial system, it would be a very difficult decision for the Chinese authorities to allow one of them to fail.

In response to Sir Martin's second question, [redacted] said that it was the case that [redacted] had only small amounts of retail deposits. Deposits below the deposit protection scheme's ceiling amounted to less than £10mn at all except one of the branches. However, although in effect wholesale deposits were largely excluded for deposit protection purposes, there was no such distinction regarding our responsibilities under the Banking Act. The Governor mentioned that, at the extreme, where an institution funded itself entirely by deposits from other banks, it would not require a banking authorisation at all. Mr Coleby drew attention to the fact that our battery of powers included the ability to restrict the taking of deposits.

Sir Jeremy Morse's view was that it was extremely undesirable for the Bank's supervision to be too statute bound. The Bank needed the flexibility to make up its own mind about what action to take. However, the Bank required information in order to make these kinds of decisions, and he remarked that he was slightly disappointed by how little information exchange between supervisors appeared to be going on.

Mr Quinn explained that some supervisors had limitations on the information they were allowed to pass on. The situation was getting better, but information exchange between supervisors would never be a complete answer to the problem. He strongly agreed that the Bank should have the sort of discretion described; we did not want to be forced into requiring subsidiarisation in all circumstances, not least because we were not convinced that it was the best protection for depositors in all circumstances. He said that HMT was preoccupied with political considerations, and appeared not to have grasped what was at stake.

Rupert Pennant-Rea

A Hoffmann
stant Secretary
24 February 1994

A COURT OF DIRECTORS AT THE BANK

THURSDAY 17 FEBRUARY 1994

Present

Rupert Lascelles Pennant-Rea, Esq, Deputy Governor
Anthony Laurie Coleby, Esq
Mervyn Allister King, Esq
Brian Quinn, Esq

Hugh Christopher Emlyn Harris, Esq
Ian Plenderleith, Esq

The number of Directors assembled being insufficient to form a quorum, those present proceeded to the business, subject to ratification by the next Court.

The Minutes of the last Court, having been circulated, were approved.

There being no comments on the weekly figures, Mr Coleby spoke about the foreign exchanges and the state of the domestic markets.

Assistant Secretary
24 February 1994

Rupert Pennant-Rea

A COURT OF DIRECTORS AT THE BANK

THURSDAY 24 FEBRUARY 1994

Present

Edward Alan John George, Esq, Governor
Rupert Lascelles Pennant-Rea, Esq, Deputy Governor
Sir George Adrian Hayhurst Cadbury
Anthony Laurie Coleby, Esq
Mrs Frances Anne Heaton
Sir Christopher Anthony Hogg
Sir Martin Wakefield Jacomb
Pendarell Hugh Kent, Esq
Sir John Chippendale Lindley Keswick
Mervyn Allister King, Esq
Gavin Harry Laird, Esq, CBE
Sir David Bryan Lees
Sir Christopher Jeremy Morse, KCMG
Brian Quinn, Esq
Professor Sir Roland Smith
Sir Colin Grieve Southgate

Hugh Christopher Emlyn Harris, Esq
Ian Plenderleith, Esq

The Minutes of the Court of 10 February were confirmed and those of the Meeting of 17 February, having been circulated, were approved.

Court gave their approval to Sir Martin Jacomb joining the Board of the Prudential Corporation plc.

There being no comments on the weekly figures, Mr Coleby spoke about the foreign exchanges and the state of the domestic markets.

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Under the weekly executive report:-

(i) Mr Kent gave a progress report on CREST. He said the Bank had been able to publish a revised specification covering broad principles. Also, the Bank had published papers covering progress on rolling settlements and ownership intentions. This broadly brought to an end the specification phase for the Bank. Mr Kent added that some external auditorial involvement would be necessary to confirm our costs were realistic, and that the systems specification meets the requirements in order to give comfort to future owners.

Sufficient spontaneous interest in the Bank's ownership paper had already been shown to make realistic the prospect of signing up future owners, under Heads of Agreement, by 3 May. The market generally was pleased with progress, especially as we were still within twelve months of the collapse of TAURUS. Mr Kent said he would return to Court with a further report in April.

(ii) Mr Harris informed Court that, as the Audit Committee were aware, Southgate House had been transferred from BE Property Holdings to the Bank with the consent of HM Customs & Excise, at a net book value of £17.8 mn. He reminded Court that Southgate House had been placed within BE Property Holdings as the VAT implications had been favourable to the Bank's cash flow. By making this transfer, the Bank would be able to value all its properties in the same manner. A decision on the future of BE Property Holdings can be made in due course.

(iii) With reference to Minutes of 26 November 1992 and 10 June 1993, Mr Quinn said Court might remember the involvement of the Bank in the supervisory arrangements in Gibraltar and the concern there had been that the Bank might be asked to take up a role for which it did not have the necessary powers. He reported that there had just been a two day conference in London with Bossano, the Chief

Minister, and UK Ministers. The Chancellor of the Exchequer had been the chief spokesman for the UK on this matter.

The most important question had been the future of the financial services sector in Gibraltar. The issues had been whether or not the appointment of a Financial Services Commissioner should be at the sole discretion of the Foreign Secretary; whether or not there should be a majority of UK representatives on the Financial Services Commission appointed by the Foreign Secretary; application of UK standards of supervision; and the corresponding changes to the Financial Services Ordinance in Gibraltar, which would be published. The object for Gibraltar was to secure the right of passport for Gibraltarian institutions into the EU.

The UK had insisted that these conditions be met before the UK would inform the EC Commission, and other member states, that Gibraltar was in compliance with the Single Market Directives. The Chief Minister had returned to Gibraltar to see if his colleagues could agree with what was proposed. The Chancellor said these conditions were not negotiable. If the Gibraltar Government did not agree to these proposals, the UK would use its constitutional powers to direct affairs in Gibraltar in this area.

Mr Quinn went on to mention the implications for the Bank. If the Chief Minister accepted the proposals, we would assist in finding a Financial Services Commissioner. There was already a provisional appointee in place with whom we were content. We would also help to find other UK representatives on the Commission; a Banking Commissioner to replace the current temporary incumbent; technical assistance in the form of one or two supervisors on secondment; and the Bank would participate in a six monthly audit in conjunction with the DTI to establish that supervisory operations were up to UK standards. Mr Quinn said he would report back to Court if, and when, the proposals were accepted by the Gibraltarian authorities.

In commenting on what Mr Quinn had said, Sir Chips Keswick warned of the dangers to the Bank. Who was to judge when the fabric was in place in Gibraltar? It would be a critical judgment as to when the Bank took over responsibility. Mr Quinn agreed with the comments. He added that the responsibility was the UK Government's, but the audit implications meant that it would be the Bank that approved. Both the Governor and Sir Martin Jacomb considered that the outcome was satisfactory, with the latter commenting that although HMT had taken control they would rely on us and, internally, we should accept this position. The Governor added we are acting as advisers for HMG: we cannot say we are not involved. Mr Quinn concluded by saying this was an important point. We would be giving assurance to other supervisors that Gibraltar was properly supervised.

(iv) The Deputy Governor advised Court of the names of the two new Non-Executive Directors that had gone to Buckingham Palace for approval.

(v) The Deputy Governor mentioned that a Channel 4 Documentary on the Bank would be shown on the coming Sunday afternoon, as part of the "High Interest" series.

There being no comments on the Accounts of the Houblon-Norman Fund for the year ended 30 June 1993, the Governor invited Mr King, in his capacity as a member of the Houblon-Norman Advisory Committee, to comment on the Report of the Committee and the work of the Fellows. Mr King said that since the 1993/94 Report, a new system had been instituted, mainly as a result of the Bank's contribution to the Fund, to mark the Tercentenary. In particular, two classes of Fellowships had been introduced, Senior and Junior, with the latter for young post-doctoral academics and in the hope of attracting more Europeans. The Fund has received some excellent applications for its 1994/95 Fellowships, in particular, from Robert Barro, a Professor of Economics at Harvard University. His proposed research topics were 'Economic Growth and Government Policies' and 'Monetary Policy as Interest-Rate Targeting'. This represented a real coup for the Bank, as Barro was outstanding in his field and a prospective Nobel Prize winner. Mr King added that there was, however, one cloud on the horizon, and that was over the question of work permits. We had had problems in the past, but the position had been tightened - particularly with regard to the Americans. Nevertheless, we would continue to press our case. The Governor thanked the Trustees of the Fund and asked that Mr King pass his thanks on to the Committee.

In accordance with the terms of reference of the Sealing Committee, the Minute Book of that Committee was laid before Court for inspection.

At the Governor's invitation, the Deputy Governor presented his paper on Manufacturing and the PRP Statement. He said the statement had been considered last year and a number of issues had been left to be considered further. Amongst these was the third core purpose and the question of whether or not the PRP should make specific reference to manufacturing. The Deputy Governor added that he felt it was worth having a direct look at this issue before considering the revised version of the PRP Statement later in the year. He commented that his paper was about neutrality. It was not anti-manufacturing. One should not single out one aspect of economic activity against another.

In opening the ensuing discussion, Mr Laird said he found himself in an ambivalent position. Although he agreed with what the paper said in terms of the Bank's PRP Statement, he found it anti-manufacturing. The paper ignored the success story of our competitors. It was the role of Government to encourage the manufacturing sector, but Government did not assist manufacturing. Whilst agreeing with the conclusions, he rejected the paper.

Sir Martin Jacomb said he found himself in sympathy with Mr Laird. He felt that it was the percentage of manufacturing activity that should be looked at, and not manufacturing as a whole. He considered the decline in genuine manufacturing was much steeper than shown in the paper. The level of our manufacturing was a serious defect in our economy; it was not competitive internationally. He added that reference should be made to the improvement of our foreign exchange earnings, and balance of trade, and manufacturing's position in that.

Sir David Lees considered the key question was the extent to which manufacturing should be referred to in the PRP statement. Who saw the Statement? Was it seen externally? The first paragraph of the paper chose between manufacturing and business as a whole, but the third core purpose did not refer to the latter. If asked the question whether or not this third core purpose should refer to manufacturing specifically, he would say no. But if it did so for the effectiveness of British business, then he would say yes. The Deputy Governor responded by saying the Statement did not have any outside exposure at the moment. If our core purposes were only for internal consumption, as was the case, then Sir David Lees felt the subject matter was less important. The Governor commented that the PRP mattered for the internal coherence of the Bank.

Sir Roland Smith said there was always a competitive situation between services and manufacturing. If we wanted an economy with momentum, then it was necessary to have growth in all aspects of the economy, not just manufacturing. For his part, Sir Christopher Hogg queried why the paper had been written. He did not see involvement with manufacturing as part of the Bank's function. The Governor responded by saying that in going through the Bank's core purposes statement, it was not clear whether or not specific reference should be made to manufacturing, as distinct from business as a whole. There were a number of dimensions to the question. Should the Bank have a direct involvement in the matter? Our conclusion was that we should have a concern for the financial sector's services to the rest of the economy. He still sensed a concern for the way financial services financed manufacturing in particular. There was a feeling within the Executive that we should be concerned about the way the financial sector financed the economy as a whole.

The Deputy Governor went on to ask if specific reference should be made to manufacturing or all users of finance. Sir Jeremy Morse did not feel it was appropriate to single out any particular sector, although the Bank should keep its eye open for manufacturing more than the retail sector. It knew all about the financial sector, but needed to work harder to learn about manufacturing. Sir Colin Southgate added that although, as Sir Christopher Hogg commented, there was evidence we cared about manufacturing, it was important that manufacturing had a voice round the table of Court in the future, as indeed should every sector. The Governor replied that there would be no reduction in our regional representation, although we might look at the way it was organised and located.

The Governor paid tribute to Sir Adrian Cadbury, Mr Laird and Mr Coleby on the occasion of their last appearances at Court. Each had made a tremendous contribution to Court especially in regard to the number of Committees on which they had served and chaired. He asked that his gratitude be recorded, together with that of their colleagues on Court, both past and present.

C · R · C [illegible]

G. A. [illegible].
Secretary.
3rd March 1994.

COURT OF DIRECTORS

For the year ended 28 February 1995

Declaration Made before	Date	
		Edward Alan John George, Esq, ~~Deputy~~ Governor
		Rupert Lascelles Pennant-Rea, Esq, Deputy Governor
The Deputy Governor	10.3.94	#Sir David Gerald Scholey, CBE
		Sir Martin Wakefield Jacomb
		Sir Colin Ross Corness
		Brian Quinn, Esq
		Mervyn Allister King, Esq
		Sir David Bryan Lees
		Professor Sir Roland Smith
		Sir Colin Grieve Southgate
		Sir Christopher Anthony Hogg
		Mrs Frances Anne Heaton
		Sir John Chippendale Lindley Keswick
		Sir Christopher Jeremy Morse, KCMG
		Pendarell Hugh Kent, Esq
The Governor	3.3.94	*Ian Plenderleith, Esq
The Governor	14.4.94	*Sir David James Scott Cooksey
The Deputy Governor	10.3.94	*Ms Sheila Valerie Masters

Reappointed 1 March 1994
* Appointed 1 March 1994

A COURT OF DIRECTORS AT THE BANK

THURSDAY 3 MARCH 1994

Present

Edward Alan John George, Esq, Governor
Sir Colin Ross Corness
Mrs Frances Anne Heaton
Sir John Chippendale Lindley Keswick
Mervyn Allister King, Esq
Sir Christopher Jeremy Morse, KCMG
Ian Plenderleith, Esq
Brian Quinn, Esq
Professor Sir Roland Smith
Sir Colin Grieve Southgate

Sir David Cooksey
Hugh Christopher Emlyn Harris, Esq

The Governor extended a welcome to Sir David Cooksey and explained that the formal announcement of his appointment as a Non-Executive Director, and that of Ms Masters, was expected shortly. He added that because of prior engagements, Ms Masters had been unable to attend Court that day. It was also noted that Mr Plenderleith's appointment as an Executive Director took effect from 1 March.

The Minutes of the last Court, having been circulated, were approved.

At the Governor's invitation, Mr Foot, the Head of Banking Supervision Division, attended Court to speak about the work of his Division. He said that he had joined the Division in June of the previous year, taking over from Roger Barnes as Head of the Division in August. Since his arrival he had been pleasantly surprised by a number of things. Morale generally was quite good, despite BCCI and all the work pressures of the previous two years; work systems and guidelines setting out responsibilities and authorities were in place and generally were well understood; and many of the intended post-BCCI changes were under way, in particular the Special Investigations Unit and the Legal Unit had been formed. He had also arrived in the Division knowing the five Deputy Heads well, and knowing that their range of experience outside Banking Supervision would stand the Division in good stead for some of the things which had to be changed. The departure of Richard Farrant to the SFA had taken away a good deal of the team's experience within BSD, but his successor was someone of very high ability with immediately relevant line management experience in BSD. In addition, of course, there was the long experience of Mr Quinn and Mr Peddie, which was invaluable.

Mr Foot said that, nevertheless, there were clear problems: there was a rather isolationist mentality within the Division; continuing very heavy work pressures in a number of areas; and, even where immediate "fire fighting" had ceased, there was a backlog of normal supervision. On the staffing front, numbers were below budget and there had been too little movement in the manager and assistant manager ranks for some years. There were too many very young and inexperienced analysts and not enough specialists. The general perception elsewhere in the Bank was that BSD was a place to avoid, on the grounds that the workload and responsibilities were very heavy and that it was often difficult to get out of the Division. There was also some doubt in the minds of the more junior staff whether the Division was central to career development in central banking. More generally, not everyone had fully adjusted to the change in ethos required post-BCCI. Mr Foot said that he had tried to respond to these problems in a variety of ways, but in some cases the changes, although made quite quickly, would take time before they were recognised and reflected in behavioural changes. For example, it was now the rule within BSD that younger staff would be released to other parts of the Bank when the Officials Development Group suggested that the timing and the move were appropriate.

Finally, Mr Foot pointed out that the work of BSD was wide-ranging and it was often difficult to forecast pressure peaks. For example, he could not have anticipated six months ago the amount of time that was now being devoted to the role of hedge funds. However, the upturn in the economic cycle in the UK did give the Division a chance to get to grips with some of the key issues that he had identified and to lift their sights away from immediate fire fighting.

In focusing on Mr Foot's Report, which had been circulated earlier, Sir Chips Keswick drew attention to the ratio of staff dealing with UK banks, compared with the rest of the world, and suggested that, as in his view most of BSD's problems were likely to emanate from banks outside the UK, that sector was rather understaffed. In response, Mr Foot acknowledged this and said that a number of staff were making parish visits in order to extend their knowledge. He hoped that the revised structure that was coming out of the Ashridge discussions would add to the resources in this area. At least some of the people currently working on the international side of the Bank would in future be working alongside those currently in BSD.

Mrs Heaton asked whether there was a greater risk from a bank suddenly becoming a problem, or from a bank causing difficulties of which BSD was already aware. In response, Mr Foot said that his remit from the Governor on taking up his current role was that there should be "no unpleasant surprises". That said, there could be a problem if a member of the staff was not sufficiently alert and missed a trick. However, there were now clear guidelines for upward reporting, which was vital in ensuring that things were not missed. He said that the role of the Special Investigations Unit was also very helpful in providing early warning of fraud, and that had been a great benefit to the Division. Other problem areas were the ongoing difficulties of establishing fitness and properness. In response to Sir Jeremy Morse's question about the right of appeal in such cases, Mr Foot explained that the process provided for the Bank to set out in writing its grounds for thinking that someone might not be "fit and proper". A written response from the individual would then be considered, and the subsequent decision ultimately required the approval of the Executive Director responsible for Banking Supervision. The decision was also subject to judicial review or, depending upon circumstances, appeal to a Tribunal (as happened last year in the Mount case).

Sir Jeremy Morse was also concerned about morale, particularly in the context of the uncertainty about jobs. In response Mr Foot said that jobs in BSD were not threatened. If there was an issue which might affect morale, it could be that some personal aspirations might suffer as a result of proposed changes following Ashridge. Referring to Sir Jeremy's comment about the post-BCCI changes, Mr Foot said that speed of response and the need for more vigorous action (where appropriate) were two of the important changes. So far as standards for fitness and properness were concerned, there was probably now more concern over competence than before. Reverting to the question of experienced staff, Sir Colin Southgate suggested that as a number of financial service institutions were shedding people, he thought that experienced staff could be available, probably on short term contract - this might be a useful source of recruitment.

In response to Sir Roland Smith's enquiry about the percentage of executive time devoted to fraud cases, Mr Foot said that although he was involved in a considerable amount of normal prudential work, senior management time - especially in dealing with the smaller banks - often focused on fraud cases. The recent introduction of training in fraud awareness had proved valuable; and with the advent of the Special Investigations Unit there were now specialist investigators working alongside the general practitioners. The analysts certainly appreciated having this professional help.

Speaking as the chairman of a building society, Sir Colin Corness asked about the practicability of splitting the supervision of retail and wholesale banking, particularly with the possibility of building societies converting to banks. The Governor said that this raised much wider issues relating to consumer protection and systemic risk, and it was a subject which Court might wish to discuss in greater depth on a separate occasion.

In response to Sir Jeremy Morse's enquiry about complaints being directed to the Banking Ombudsman, Mr Foot said that whilst some complaints were referred to the Ombudsman, BSD did look at those that might have a systemic impact. He identified one case where the Bank's first indication of a major fraud arose from complaints made by three different customers.

In winding up the discussion, Mr Quinn said that he had been impressed and greatly encouraged by Michael Foot's impact on the Division. There was a very young senior management group of six people, and he was confident that they would weld into a good team under Michael Foot's leadership.

Mr Quinn commented on the weekly figures and Mr Plenderleith spoke about the foreign exchanges, including the Official Reserves figures for February, and the state of the domestic markets.

In presenting the Economic and Financial Report for February, Mr King said that the last month had been an extremely interesting one. Not only had there been a sharp fall in many financial markets, especially bond markets, but there had also been a rather mixed bag of economic statistics, plus the adverse market reaction to the quarter point reduction in interest rates a month ago.

At the time of the Governor and Chancellor meetings in January and February, the latest data were almost uniformly positive, with inflation lower than expected and indications of continuing growth in both output and retail sales. Over the past month the figures on activity had been more mixed. For the first time for five months, unemployment rose in January (s.a.), manufacturing output in December fell, and there was a small fall in consumer confidence. Against that, the estimate of total output in the economy as a whole for the fourth quarter was revised up slightly, and retail sales grew by 0.6% in January. House prices had risen by 2.2%, according to the Halifax Building Society. Perhaps more important, turnover in the housing market had increased considerably. The picture as a whole was very much that painted in the forecast made at the time of the Budget. As yet, there was no evidence that the impending tax increases were likely to prevent the economy from growing at around 2-3% during this year, although of course the proof of the pudding would be in the eating.

On the inflation front, underlying inflation - measured in our preferred way, which excluded indirect taxes - was 2 1/2% in the year to January. The Government target measure - RPIX inflation - was 2.8%, a little below the anticipated level of 3%. Commentators had accused us of getting our forecast wrong all the time. The short-run 'forecast' was simply a benchmark against which to assess the news embodied in new data. Our view of what inflation was likely to be in 12 to 24 months' time had not changed very much - other forecasts had tended to come down towards ours. But it was worth noting that our projections for the next two months were for a sharp fall in RPIX inflation, followed by an upturn in April as the tax increases came through.

Looking ahead, as we must do for monetary policy, these latest inflation data make rather little difference to our projection of inflation some two years ahead, as given in the Inflation Report - 2% to 3% according to the Bank's measure of underlying inflation, RPIY. It was important that monetary policy was seen not as a reaction to the latest inflation statistic but as reflecting a judgement about the direction in which inflation was heading some two years hence. Lower than anticipated inflation may help expectations of future inflation to adjust more rapidly, and help to hold down the growth of money, wages and costs. Also relevant to the future were the growth rates of the monetary aggregates. These had fallen back a little over the past month, especially for broad money.

What did the rise in bond yields tell us? About half the rise in yields reflected expectations of higher real interest rates in the future, and about half reflected expectations of higher inflation. It was possible to derive an estimate of what the markets expect inflation to be because we had index-linked bonds in this country: comparing their yields with those on conventional gilts allows one to calculate an inflation term structure.

For policy, the situation had been more than a little awkward. Last month's rate reduction was somewhat hard to justify in terms of the evidence available over the previous month, and the market reaction was adverse. Inflation expectations and anticipated future interest rates rose following the cut. And the exchange rate fell. The more mixed indicators over the past month would have provided a better backdrop to any rate reduction. But the fact of last month's reduction had altered the position. Long term interest rates were sharply up. And the exchange rate was some 1% lower than a month ago. That in itself would constitute a stimulus to net trade, and would help to offset the rise in real interest rates. The strongest case for a further reduction in official interest rates would be evidence of a further slowing down of the economy, perhaps as a result of the tax increases, for which there was as yet no evidence. That evidence may appear over the next month - or it may not. There was no need to prejudge that.

In introducing the discussion on monetary policy, Mr Plenderleith identified a number of factors that were important in the current considerations for policy. There had been some rather mixed activity data recently but the course of inflation was encouraging. Although M0 was above its monitoring range, it was not a cause of concern at this stage; and the notes and coin component had slowed a little in the past month. This suggested that there was little evidence yet of any slackening in retail activity. M4 had grown more slowly in January, to record an increase over the past 12 months of 5 1/2%, in the middle of its monitoring range; this was some relief, since it came after three months in which the aggregate had accelerated rapidly. Lending still remained sluggish; but there had been considerable corporate activity in the capital market with a substantial calendar of new issues to come in the next few weeks, if the market regained some stability.

Alongside these data, the recent cut of 1/4% had not been well received and there had been some questioning of credibility in our policy stance. This, and the highly disturbed situation worldwide in the bond markets, led to a sense in the markets that the current policy stance was likely to remain for the time being, but with close attention being paid to any indication of the impact of the April tax measures on spending.

In the discussion, Mr King responded to Sir Jeremy Morse's enquiry about the adverse reaction to the recent 1/4 percentage point cut, saying that at the briefing, the press had been suspicious about the reasons for the change because of the lack of any supporting evidence for a cut over the previous month. Mr Plenderleith commented that the cut had been related to inflation figures that for several months had been lower than we expected, which we had assessed genuinely carried through to a lower medium-term prospect for inflation; hence the timing had been to coincide with the publication of the Inflation Report. As we felt that the upside risks attaching to our inflation projection in the Report were greater than the downside, a cut of a 1/4 percentage point rather than a 1/2 percentage point cut had been appropriate, but this had caused some people to question why any cut had been made at all. However, with interest rates now at low levels, movements of 1/4 percentage point were appropriate.

In commenting on inflation generally, Sir Roland Smith said that businessmen and managers had little confidence that low inflation would be maintained and this affected their attitude towards pay policy, and pricing etc. He said that consumers were looking for value, so there was a need for retailers to take great care in their pricing and promotion policies. Sir Colin Southgate, in agreeing with Sir Roland Smith, said that it would take time for businessmen to get used to low inflation. The Governor agreed: it had taken the economy a long time to adjust to high inflation, so it was not surprising that it was now taking time to adjust the other way.

Under the weekly executive report:-

1 With reference to a Minute of 27 January, Mr Harris reminded Members of Court of the intention for the Officials' bargaining unit to combine performance awards with the across-the-board pay award to be effective from 1 March. This entailed bringing forward the across-the-board award from 1 July, a settlement just eight months after the previous one. An increase of 1.7% had now been accepted by BIFU on behalf of the Officials' bargaining unit. The same percentage increase had been applied to the salary points of the Senior Officials.

So far as the London EDP staff were concerned, Mr Harris said that, following conciliation at ACAS, staff had been balloted on a package which included a restructuring of the pay scales with an across-the-board increase of 1%, and a one-off non-pensionable sum of £140 with effect from 1 March. The result of the ballot would be known later that day.

For the Printing Works staff, the Bank has traditionally followed the national settlement for the printing industry, with the nationally agreed flat rate sum being translated into a percentage across-the-board increase by application of an accepted formula. Employers and Union representatives had agreed this week to recommend an increase of £5 per week for craftsmen. If accepted, this would lead to an across-the-board increase for staff at Debden of between 2.5% and 3%, to be effective from 1 May 1994.

Negotiations were also in train at Gloucester for a settlement to be backdated to 1 March 1994. It was hoped that agreement would be reached today giving an increase of 2.25% plus £100 on pensionable pay.

For the catering staff, BE Services had offered 1% across-the-board with effect from 1 March 1994, but this had been rejected by BIFU. Both sides would now go to ACAS for conciliation.

Finally, Mr Harris reminded Court that the settlement date for the main bargaining unit for Bank Officers was 1 July.

The Governor drew Members' attention to the statement in Members' folders setting out details of the Senior Officials' promotions, effective from 1 March 1994.

2 Mr Quinn informed Court that there would be a press announcement on Tuesday 8 March that the new £50E note would be issued on 20 April. This would be the last of the new Series E notes to be issued.

Secretary 10 March 1994.

A COURT OF DIRECTORS AT THE BANK

THURSDAY 10 MARCH 1994

Present

Rupert Lascelles Pennant-Rea, Esq, Deputy Governor
Sir David Gerald Scholey, CBE
Sir Colin Ross Corness
Mrs Frances Anne Heaton
Sir Christopher Anthony Hogg
Sir Martin Wakefield Jacomb
Sir John Chippendale Lindley Keswick
Sir David Bryan Lees
Ms Sheila Valerie Masters
Sir Christopher Jeremy Morse, KCMG
Ian Plenderleith, Esq
Professor Sir Roland Smith
Sir Colin Grieve Southgate

Hugh Christopher Emlyn Harris, Esq

The Deputy Governor extended a welcome to Ms Sheila Masters on the occasion of her first attendance at Court.

The Minutes of the last Court, having been circulated, were approved.

There being no comments on the weekly figures, Mr Plenderleith spoke about the foreign exchanges and the state of the domestic markets.

At the Deputy Governor's invitation, Mr Harris introduced a paper which reviewed the workings of Court and its Committees over the past year. He said there had been significant changes to the papers presented at Court and the nature of the discussions in recent years: he invited Members to comment on some of the issues raised in his paper.

In response, Sir Christopher Hogg said that he endorsed the changes that had been made since he joined Court. However, he remained strongly opposed to the weekly meeting although he appreciated that it was necessary to conform with the Statute. He felt that a series of short meetings was counter-productive. It was not possible to attend regularly and there was, therefore, a lack of continuity. Additionally, it was difficult, under the present pattern of Courts, to fill the weekly agendas with meaningful topics. He accepted that the Court of the Bank was rather different from the board of a public company, and that the Bank was bound by a variety of restrictions which limited the scope for wide ranging discussions. He was, however, content to wait and see how things continued to develop.

Sir Colin Corness suggested that the requirement to have a weekly meeting could be changed by an Order in Council and that an Act of Parliament was not necessary. That being the case, he suggested that one meeting a month would be appropriate, for targeted topics, leaving domestic matters for the attention of the Executive. If more frequent meetings were necessary, he suggested that Directors' other commitments to the Bank should be reduced. During his period of service he had been active in seeking to stand down a number of Committees, not just because they were time consuming, but because in his view he felt that they were dealing with issues which should be dealt with by the senior management of the Bank.

In agreeing with both Sir Christopher Hogg and Sir Colin Corness, Sir David Lees said that, as an interim measure, he would like to see two long Courts each month and no Court of one hour's duration. Time taken in travelling to attend a meeting of one hour was not time well spent. So far as the agenda items were concerned, Sir David was strongly of the view that much more time should be devoted to a discussion of the

Inflation Report, and in advance of its publication. He was supportive of Branch visits and of Heads of Functions appearing before Court to discuss issues relating to their areas. He said that the Minutes were very helpful, but should be sent out to Directors in advance of Court, preferably by the Tuesday or Wednesday preceding. He was fully in agreement with Sir Colin Corness about the abolition of Committees, and Staff Committee in particular.

Sir Chips Keswick said that, in his view, the main function of the Non-Executive Directors was to provide a constant supply of meaningful information to the Bank's Executive. The weekly meeting of Court was an effective way of achieving this.

Sir Jeremy Morse suggested that, from the Governors' point of view, the problem was that it was difficult to predict with any accuracy how much time should be devoted to each subject. He suggested, therefore, that one three hour meeting a month would give far greater flexibility to allow a discussion to run if necessary. He said that apart from the cost in time to Directors in having to attend weekly meetings, there must be a considerable cost to the Bank as well in preparing for so many meetings. His preference would be to move to one long meeting a month as soon as possible. Sir Jeremy also endorsed the need for the Minutes to be sent out in advance of the meeting. He disagreed with the abolition of Staff Committee.

Sir David Scholey also supported a move to a longer meeting once a month. Amongst other things, this would generate a greater commitment to attend. He was also concerned about the interaction between Members of Court and the Executive. Non-Executive Directors' views had been sought on several occasions about the workings of Court, but at no time had they heard what the Governors would prefer. On the other hand, the deliberations of the Executive at Ashridge were presented to Court without any participation from Non-Executive Directors. Sir David suggested that the ideal model had been the manner in which the "independence" issue had been dealt with. This had been a high point of the Court calendar, which had been reflected in the quality of the debate. He suggested that Court would want to hear about the changes in management responsibilities which will come about as a result of the new structure emanating from the Ashridge discussions. Sir David was also content with the Minutes of Court in their present form, but endorsed the suggestion that they should be circulated in advance of the meeting.

So far as frequency of contact was concerned, Sir David Scholey suggested that, if there was a move towards less frequent full meetings of Court, perhaps the "local" Non-Executives could join the Governors more frequently on either a formal or informal basis, possibly for lunch. Much would depend on the extent to which the Governors valued and needed the regular views of the Non-Executive Directors. Sir David was fully supportive of the move to reduce the number of Committees, but noted the need to retain the Audit and Remuneration Committees. He very much regretted the disappearance of the name of the Committee of Treasury and suggested that the name might be preserved, albeit to be used by another Committee with different terms of reference.

In commenting on Directors' visits to Offices and Branches, Sir David said that in his early days as a Director he found them very valuable. He would not wish to stop the practice now, but suggested that one visit every other year might seem to be about the right degree of frequency. He was supportive of the continuation of Heads of Functions Reports to Court. He thought it was a valuable experience for the Heads of Functions themselves, and gave an opportunity to Members of Court to see how they performed.

In supporting the move to one long Court a month, Sir Colin Southgate said that there was little depth in the discussions at shorter Courts, and the agendas were often filled with items with which he would not become involved in his own Company. Sir Colin said that it would be quite appropriate for Non-Executive Directors to attend lunch with the Executive more frequently to give help and advice, but he would be strongly against any move which attracted only "local" Non-Executive Directors to attend more frequent short Courts: this would create a "them and us" situation to which he was strongly opposed. He supported Sir David Scholey's view that the Governors should present their views on what they required from the Non-Executive Directors, the purpose of Court, and how it should run.

In focusing on the reports from Heads of Functions, Sir Colin suggested that these should be part of the overall budget presentation and should not feature on the agenda on a monthly basis. He suggested that it might be appropriate for the Reports, which might focus on budget aspects, to be made all at one long meeting. Sir Colin was critical of the need to have Committees and suggested that the Debden and Staff Committees served no useful purpose; but he supported the need for the Audit and Remuneration Committees.

In speaking about the frequency of Courts, Sir Roland Smith said that the important issue was the need for interaction. This was difficult to achieve in a one hour meeting but worked well in longer meetings. He did not like the present system of Reports of Heads of Functions at Court, because they involved the Non-Executive Directors in the management of the Bank; he had always favoured less formal discussions in Staff Committee. The present arrangement was not a good use of time and he would prefer that time devoted to such issues as a discussion of the Inflation Report. Sir Roland said that he was still confused about the role of a Non-Executive Director: was it to provide a constant supply of information, as Sir Chips Keswick had mentioned earlier, or to give guidance on the management and development of the Bank?

In supporting a monthly long Court, Sir Martin Jacomb said that the Bank should not lose sight of the need for some weekly role on the part of the Non-Executive Directors if there was a move towards substantive independence on monetary policy. This should be taken into account when considering the future pattern of Court. Sir Martin agreed that visits to Branches and Offices were of little value and supported the move to reduce the number of Committees. He felt that there was some value in retaining the Heads of Functions Reports to Court, but that they should have a lower profile in the overall agenda: in practice, the views of Non-Executive Directors could be of value to the Heads of Functions. Sir David Scholey agreed that visits to Branches were of little value, but thought that visits to specific offices were informative for the Non-Executives.

Mr Plenderleith said that he found the contribution from Non-Executive Directors on policy issues enormously helpful. He agreed that the interaction on a regular basis between Executive and Non-Executive Directors was something that he would not wish to lose.

Mrs Heaton thought that Court should be interested in the Reports of the Heads of Functions, but she felt they would be more so if they dealt with policy issues. It was when policy issues were before Court that the level of discussion was at its best. She supported the need to maintain links with the Departmental Heads, but suggested that this should be done through the budgetary process rather than by formal Reports to Court. She welcomed the process of producing green papers for discussion at Court and supported Sir David Scholey's comments about the lack of any involvement of Members of Court in the Ashridge discussions and proposals. Overall, Mrs Heaton supported the move towards fewer, longer Courts; but at the same time she saw advantages in maintaining a weekly link between the Non-Executive Directors and the Bank on market information. In conclusion, Mrs Heaton noted that during her time on Court she had attended a number of lunches but was surprised that neither Officials from the Treasury nor Ministers had been invited on any of these occasions.

The Deputy Governor said that he took note of the helpful comments that had been made by Members of Court regarding the length and pattern of Courts and he would discuss the matter further with the Governor.

Moving on to consider more specifically the need to retain the Debden Committee, the Deputy Governor invited Mr Jarvis, the General Manager of the Printing Works, to join Court.

Mr Jarvis said that there were three particular benefits which arose from the Debden Committee. In the first instance there was the question of staff morale. Members of the staff at the Printing Works valued the time that the Non-Executive Directors spent with them, particularly those Non-Executive Directors with an industrial background, and the continuity of membership of the Debden Committee was particularly valuable in this respect. The fact that Members of Court took an interest in the Printing Works helped to counter the "second class citizen" attitude of some staff. Secondly, Mr Jarvis focused on the accountability of the Printing Works management. It was a discipline for the Managers to appear before the Committee to justify past performance and to set targets for the future. Invariably, discussions in the Debden Committee led to new ideas and these were particularly helpful. Thirdly, was the advisory role that the Debden Committee brought to the management of the Printing Works, particularly because of the lack of any real industrial experience on the part of the Bank's Executive. Many of the Non-Executive Directors were used to issues such as R&D, and refurbishment, etc. and their contributions on these sorts of issues were particularly valuable. From his personal point of view, Mr Jarvis said that he appreciated the independent views and the support of the Non-Executive Directors on the Debden Committee. In thanking Mr Jarvis for his comments, the Deputy Governor enquired whether these benefits might be achieved in another way?

Sir Colin Southgate said that it was not a good use of Non-Executive Directors' time to sit on the Debden Committee. The Printing Works was a relatively small operation with a single product. It was well-run and it was interesting to be involved in it, but it did not require the expertise of four of the Bank's Non-Executive Directors. Sir David Scholey said that he did not see the need for a Committee structure, such as the Debden Committee, to manage the Printing Works. From his own experience with a subsidiary company of Warburgs that was involved in copper refining, the board was chaired by an executive, with one member being non-executive appointed from industry. He suggested that a similar solution might be practical for the Printing Works.

Mrs Heaton, who was currently a member of the Debden Committee, supported Sir Colin Southgate's comments. But Sir Roland Smith questioned how the Bank would deal with the challenges and problems that existed at the Printing Works, in the absence of the Committee. Any change would require careful communication. Sir Jeremy Morse suggested that because of the unique and very public profile of the Printing Works, the Bank needed to safeguard the operation. In response, Sir David Scholey said that, despite the present structure, things had gone very wrong at the Printing Works recently and the matter had been left to the Audit Committee to resolve.

In summarising the discussion, the Deputy Governor said that he was grateful to Court for their comments on this subject. It would now be for the Executive to think how matters should be taken forward in respect of the Debden and Staff Committees and particularly in seeking the expertise of particular Non-Executive Directors on staffing policy and on industrial issues at Debden, and on market related issues if Court met less frequently. The matter would be brought back to Court in due course. In the meantime, he thanked all Non-Executive Directors for their service on the various Committees.

The membership of the remaining Committees and of the Trustees of the two Pension Schemes were noted, together with the other changes to subsidiary company boards and to Trusteeships as set out in Mr Harris's note of 9 March, namely:-

COURT COMMITTEES, ETC FOR THE YEAR TO 28 FEBRUARY 1995

<u>Remuneration Committee</u>

Sir David Scholey - Chairman
Sir Martin Jacomb
Sir Colin Corness
Sir David Lees
Sir Roland Smith

<u>Trustees, Court Pension Scheme</u>

Sir Colin Corness - Chairman
Sir Roland Smith
Sir Chips Keswick

<u>Audit Committee</u>

Sir David Lees - Chairman
Sir Colin Southgate
Sir Jeremy Morse
Sir David Cooksey
Ms Masters

<u>Trustees, Staff Pension Fund</u>

Sir Martin Jacomb - Chairman
Sir Christopher Hogg
Mrs Heaton
Sir Chips Keswick
Mr Kent
Mr Harris

<u>Sealing Committee</u>

Any three members of Court

<u>Houblon-Norman Fund</u>

Deputy Governor
Sir Roland Smith
Sir Jeremy Morse

<u>BE Nominees Ltd</u>

Deputy Governor
Mr Plenderleith

<u>BE Services Ltd</u>

Lord Laing - Chairman
Mr Harris
Mr Jarvis
Mr Mitchell
Mr Watts
Mr Bridger

<u>BE Museum Ltd</u>

Mr Harris - Chairman
Mr Footman
Mr Croughton
Mr Hills

At the Deputy Governor's invitation and with the agreement of Members of Court, [redacted] [redacted] and the author of a paper 'Reverse Money Illusion', attended Court, together with [redacted], for the ensuing discussion.

The Deputy Governor said that the message the Bank wanted to give was that if we achieve and maintain low inflation, the economic behaviour of all groups must change. The paper brought all the points together. The Deputy Governor invited Members' views on the paper and its theme, and also comments on some of the specific issues raised, such as hurdle rates for investment decisions and the attitude of financial institutions towards investment appraisal.

Sir Christopher Hogg said that the Bank needed to hammer home the points raised. The implications of lower inflation were not well understood by the public and were difficult to grasp conceptually. There was a danger of assuming too high a level of sophistication amongst the Bank's audience. The Bank had the right message, but it also needed to take the right public relations approach. Sir David Scholey agreed that some organisations aspired to very high rates of return, which might be attainable in the short run but were not sustainable. The Bank would have to adopt a "Daily Mail" level of communication to convey its message. It would take real thought to do this well, but it was necessary if one was to get through to managers of subsidiary businesses, for instance.

Sir Jeremy Morse felt that the paper mixed up observations and recommendations. Managers were in fact divided about whether we were now in a low inflation environment, or whether inflationary pressures had merely been temporarily suppressed; the former camp had received some support from recent data. The title of the paper was too oblique. It implied that there was a temporary, transitional problem while inflation expectations were brought down. But the paper also considered long-run problems, such as how firms ought to make their investment decisions.

Sir Chips Keswick argued that the Bank's message should be transmitted at all levels, and agreed that the "Daily Mail" level was vital. A lot of his business customers were just waiting for a bit more growth to allow them to put their prices up. Sir Colin Corness believed the man in the street was still sceptical about the maintenance of low inflation. He cited two pieces of supporting evidence: two-thirds of mortgages were being taken out at fixed rates at the moment, and money was moving out of deposit accounts with attractive real interest rates into equity markets despite the high valuations of the latter. The Bank had a key role to play in educating the public.

Sir Martin Jacomb argued that the Bank needed to establish to whom it wanted to deliver its message and why. He thought an investment-led recovery was needed, so the Bank should concentrate on potential investors. Investment rates had been poor not so much because of high inflation, but because the inflation expectations of lenders and borrowers had diverged so much. The Governor's speech should have a less didactic tone, but to state clearly that inflation would remain low and to spell out the consequences. Sir David Lees said that he thought the Bank was in a long race but should start the conversion process now. The message would have to be put over in simpler terms. The Deputy Governor reminded Court that the paper was not intended to be a text for a speech. He agreed that the Bank needed to concentrate on one message at a time.

Sir Colin Southgate believed that the rates expected by venture capital funds were obscene. The development of new and small businesses was very important and was impeded by such rates. This should be part of the Bank's message. It ought to be simplified and got into the media. Sir Jeremy Morse said that he was still unclear about whether the Bank's stance was a positive or normative one. Sir David Scholey agreed that the message needed to be conveyed to ordinary managers. He was grateful for a very stimulating paper and an opportunity to discuss the issues it raised. The Deputy Governor clarified the message we wanted to give: the current lull in inflation was not merely a prelude to prices taking off again. If this was not believed, the country would not see the investment necessary to sustain steady growth. Sir Colin Southgate pressed for the Bank to reiterate that inflation should be still lower - say, 2% - and was not satisfied with the current level.

The Deputy Governor asked Mr Miles, the paper's author, if he wished to add anything. Mr Miles agreed with Sir Jeremy that there was a distinction between the problem of the transition to low inflation and the problem of how investment decisions ought to be made. The reluctance of many of the 200 firms surveyed by the Bank's Agents to reduce their target nominal rates of return over the last year was probably an example of a transitional problem. But the fact that a third of firms insisted on specific payback periods - and very short ones at that - was a longer-term problem.

Under the weekly executive report and with reference to a Minute of the previous week, Mr Harris said that the ballot following the pay negotiations for the London EDP staff which had taken place the previous week, had resulted in 108 votes against the Bank's proposals for restructuring the pay scales and 54 votes in favour. As a result, the Union proposed to hold a ballot for industrial action the following week. In the meantime, however, 140 members of the Bank's EDP staff had responded to personal letters from the Bank, accepting the terms of the pay package. Management were confident that contingency plans would allow for all systems to function normally.

for H Hoffmann
Assistant Secretary
24 March 1994

Rupert Pennant-Rea

A MEETING OF DIRECTORS AT THE BANK

THURSDAY 17 MARCH 1994

Present

Edward Alan John George, Esq, Governor
Rupert Lascelles Pennant-Rea, Esq, Deputy Governor
Pendarell Hugh Kent, Esq
Mervyn Allister King, Esq
Ian Plenderleith, Esq
Brian Quinn, Esq

Hugh Christopher Emlyn Harris, Esq

The number of Directors assembled being insufficient to form a quorum, those present proceeded to the business, subject to ratification by the next Court.

The Minutes of the last Court, having been circulated, were noted.

There being no comments on the weekly figures, Mr Plenderleith spoke about the foreign exchanges and the state of the domestic markets.

A Hoffmann
Assistant Secretary
24 March 1994

Rupert Pennant-Rea

A COURT OF DIRECTORS AT THE BANK

THURSDAY 24 MARCH 1994

Present

Edward Alan John George, Esq, Governor
Rupert Lascelles Pennant-Rea, Esq, Deputy Governor
Sir Colin Ross Corness
Sir Martin Wakefield Jacomb
Pendarell Hugh Kent, Esq
Mervyn Allister King, Esq
Sir David Bryan Lees
Sir Christopher Jeremy Morse, KCMG
Ian Plenderleith, Esq
Brian Quinn, Esq
Professor Sir Roland Smith

Hugh Christopher Emlyn Harris, Esq

The Minutes of the Court of 10 March and the Meeting of 17 March, having been circulated, were approved. Leading on from the Minutes of 10 March, and the discussion on the workings of Court, the Governor said that advice has been taken as to whether or not having only one substantive meeting per month was consistent with the Bank of England Act. The conclusion was that there was no obstacle to this, provided that any Member of Court was welcome to attend the shorter meetings. However, the expectation would be that Non-Executive Members would attend the Long Court meetings.
The Governor went on to say that he proposed that the new Long Courts, which would start after the summer, should begin at 10.00 am, and we would see how this worked out. In the meantime, the Secretary would get in touch with Non-Executive Directors to see which regular day in the month would be the most convenient to them. A set of provisional agendas would

then be prepared. One factor, that would have to be taken into account was the timing of the Inflation Report, as it would be necessary to consider the draft before publication.

The Governor continued by saying that he did not intend that Heads of Departments' Reports should be taken at Long Court meetings. They would still feature, but would be part of an annual strategy morning, concentrating on the issues facing the Bank for the year ahead, which he proposed holding each autumn. This meeting, which it would be sensible to make the thirteenth Long Court, could begin with reports from the Heads of the main functions covering the significant issues they saw arising in the period ahead, before Court went on to discuss the Bank's priorities. The Governor added that he appreciated some Members of Court were keen to have more regular contact with the Executive than just at the monthly Long Court. He proposed that this should be accommodated by Non-Executive Directors being invited to lunch on a regular basis on one or two days a month, as well as by informal contacts in between. In response to a question from Sir Colin Corness, the Governor said it was proposed that the Debden Committee should be stood down. The Printing Works would be accountable to the Executive Director and, through him, to Court.

Mr Quinn commented on the weekly figures and Mr Plenderleith spoke about the foreign exchanges and the state of the domestic markets.

The Governor mentioned to Court that the interim payment, in lieu of dividend, was due to be made to HM Treasury on 5 April. The Deputy Governor went on to say that the annual payment had, in recent years, been governed by a formula under which the Bank and HM Treasury shared post-tax profits on a 50:50 basis. This formula had expired with the 1993 accounts, and discussions were continuing with regard to a replacement formula. The Deputy Governor said he would report back to Court once this had been resolved. In the meantime, and in connection with this year's interim payment, operating profit for 1993/94 was estimated at £108.9mn. Court would be receiving a full report on the profit and loss account the following month. The Bank had agreed with HM Treasury that the costs of CREST, estimated at £1mn in 1993/94, would be borne by the Bank. Leaving this item aside, the agreed formula produced a dividend of £44.7mn, tax of £20.2mn and an interim dividend of £22.35mn. The previous year's profits had been reduced by support operations. It was not anticipated that any extra provision would be necessary this year. On the question of CREST and its costs, the Chancellor feels that the operation should have been handled in the private sector and not by ourselves. It was, however, something we wanted to do here as a one off, although we might have to accept other situations where costs would be generated that would fall outside the normal formula.

Court agreed that, pursuant to Section 1(4) of the Bank of England Act 1946, an interim payment of £22.35 mn be paid to HM Treasury in lieu of dividend on 5 April.

Court gave their approval to Mrs Heaton joining the Board of Commercial Union plc.

With the agreement of Members of Court, [redacted] and Mr Clark, the Head of European Division, attended Court for the following discussion.

Mr King introduced two unrelated issues which Economics Division had been considering recently. The first concerned the Bank's Submission to the enquiry by the House of Lords European Communities Committee addressing unemployment problems in the European Union, and the second related to manufacturers' margins. Turning to the paper on unemployment, Mr King said that the jobless rate in Europe had increased dramatically over the past 20 years. It rose every year in the Community between 1973 and 1986, from 3 to 11 per cent. After 1986 it fell slowly until 1990, since when it had risen steadily. Most international economic meetings are dominated now by discussion of jobs. President Clinton had convened his Jobs' Summit ten days previously, the European Union had discussed a Commission paper on unemployment, and the OECD will release a major report on unemployment in the summer. Over the past two or three years, there had been a continual disagreement between the Americans on the one hand, and the continental Europeans on the other. Some continental countries have argued that all unemployment is structural. The Americans, in contrast, believe that much European unemployment is cyclical, and could be reduced significantly by an expansion of demand led by lower interest rates. Mr King said he had a great deal of sympathy for the Americans in this debate. The level of unemployment reflects both blades of the scissors, aggregate demand on the one hand and supply-side policies on the other. It is literally incredible to suppose that all unemployment is structural. We certainly do not believe that for the UK.

But there are major structural weaknesses in European labour markets. Parallel to the macroeconomic debate has been the observation that labour markets in the US have performed very differently from those in Europe. In the 1950s and 1960s, unemployment in the US was always substantially above that in Europe. Over the past decade, it had been substantially below. But this was not because workers in the US become unemployed less frequently than in Europe. On the contrary, the rates of inflow into unemployment are much higher in the US than in Europe. The big difference between the US and Europe is in the duration of unemployment: the average is five to ten times higher in Europe than in the US, and nearly half of Europe's unemployed have been out of work for over a year.

Why is there such a big difference between Europe and the US? There are two aspects to the story. First, in the long run the level of unemployment reflects the cost of employing labour relative to the living standards which an unemployed person can obtain from state benefits. It is clear that in Europe there are significant costs to the employer of employing low skill labour, which may take the form of higher employment taxes or costs of hiring and firing, and benefit levels are higher. Second, when there is a sharp adverse movement in aggregate demand, the rise in unemployment which inevitably follows is slower to reverse itself in Europe than in the US. Labour mobility is less in Europe than in the US, and real wages adjust more slowly to adverse shocks in Europe than in the US.

Finally, Mr King said, the paper pointed to a number of long-term developments which have a bearing on the potential wages that can be earned in the market by the unskilled. There is likely to be downward pressure on the wages of unskilled workers over the next few decades, because of the growing integration of the world economy and more successful development policies by countries such as China, Latin America, and Eastern Europe. Governments will be faced with a real challenge: either workers must become more skilled in order to earn an acceptable market wage, or society will have to accept the consequences of increasing wage differentials, bearing especially upon those at the bottom end of the distribution. There are no short cuts to reducing unemployment, but it is equally misleading to suppose that we are condemned to unemployment at current levels indefinitely.

In opening the ensuing discussion, the Governor said that he found the paper both interesting and useful. Sir Jeremy Morse noted that a lot was being written about this subject at the moment. Most of it concentrated on the relative unemployment rates of different countries, rather than on the overall level of unemployment in the world economy as a whole. He felt that too much attention was paid to the relative position. He was sceptical also about the quality of unemployment statistics, noting that the United States used different methods of collection from the Europeans. Nevertheless, he was still puzzled by the differential between the United States and Europe. He had thought that the past higher mobility and lower benefits in the United States were now converging on European levels. He noted that politics was very important in influencing the arguments about this issue.

Sir Roland Smith wondered whether changes in competitiveness were responsible for the differences in unemployment. He thought that the European Community had probably become less competitive over the past few years. The UK favoured open markets, more competition and thus improved competitiveness. This was why policy recommendations in the UK differed from those on the Continent. There, people advocated spending a lot of money on training and similar long-term measures. It appeared the French actually wanted to be more protectionist, less open and, therefore, less competitive. Sir Roland thought that the impact of the benefit system's rules should be considered more. Changes might reduce long-term unemployment in particular.

Sir David Lees noted that there was an incessant drive for productivity growth in manufacturing. Firms needed 4 to 5 to 6% productivity growth each year to remain competitive, but demand was growing by 1 only to 2 to 3% each year. This inevitably put pressure on employment. Employers are more disinclined than ever to employ at the margin. There is also now a philosophy of not taking on a permanent workforce, but instead temporary and contract workers. Sir Colin Corness said that firms were reluctant to take on unskilled or semi-skilled workers and spend money on retraining them. He was interested also in the point raised in the paper about the shortage of low-cost rented housing in this country. He asked what research had been done on this issue, in particular the comparison between the United Kingdom and the United States, where there was a much larger rental sector.

Sir Martin Jacomb said that he found the paper extremely useful, but felt that in practice the prospects for employment were worse than the paper implied. This would have been evident if the first graph in the paper had been extended back earlier and if non-productive jobs had been counted as well as unemployment. Other countries seemed to be quicker in adapting to new technology. Keynes had noted that the price of free access to the developed world for the products of the less developed world should include assurances on the improvement of wages and conditions of workers in the latter, so as to reduce the effect on labour in the developed world. Mr Quinn emphasised that the differences between the United States and Europe were huge. He did not think that they could be explained by differences in the collection of statistics. He drew attention to the fact that there had been very little growth in real incomes in the United States for many years, so there was a trade-off between growth in the number of jobs and the growth in pay. The fact that there is an international market for traded goods affects the level of pay that any particular job can command. In this country, those who have been in work over the last few years have had higher pay than they would otherwise have done. Mr Clark said that there had been an increasing dispersion of wage rates in the United States, but not in Europe. He took this to mean that real wage rates were approaching more closely the true marginal product of different workers. Sir Colin Corness noted that the wage rates which his company had to pay in Texas had been flat for 7 years. Sir Roland Smith wondered if the distribution of employment in the United States was very different from that in Europe. Europe seemed to be stronger in the mature products but not in new areas, although the UK was perhaps a bit better. Unemployment would remain high as long as this was the case.

Mr King reminded Court that unemployment was still a lot lower in Germany than it was here. He agreed that there was a trade-off between real wages and unemployment. But unemployment benefit rules and levels and other factors influenced by governments could affect the terms of this trade-off. He thought that the word competitiveness ought to be banned. Its use implied that trade was a zero-sum game. But trade enriches everyone who participates in it. The real question was the productivity that could be achieved in industries, as it was this that determined real income.

The Governor said that this was a difficult issue for the Bank. Our credibility in the economic debate required us to consider such issues as unemployment. The consensus internationally for stable macroeconomic policies was under threat, because of the political concern aroused by higher unemployment. We had to restate the case that the greatest help we can give to reducing unemployment is to guarantee the maintenance of a stable macroeconomic framework. The second concern of the Bank was to ensure the effectiveness of the financial system in delivering finance for investment, particularly by small businesses. Sir Jeremy Morse agreed that these were the two main reasons why the Bank should talk about unemployment. We had to show that we were fully up to the debate about unemployment, in order to rebut the arguments against macroeconomic stability. As for the efficiency of the financial system, it was not just an issue for small businesses. It was also important, for instance, in work-outs for big companies which had run into trouble. It had to be shown that in such circumstances we worked to minimise the unemployment costs of reorganisation. Sir David Lees thought there was a third reason why the Bank should be concerned. This was the fact that growing unemployment had consequences for public expenditure and fiscal policy. Spending on unemployment benefits was not productive.

Mr King then introduced the topic of manufacturers' margins. He said that it was necessary to start with the rate of return of capital, because it was this which generated a return to suppliers of finance and it was this which was the appropriate measure of the cost of investment to producers. He would first review the facts about margins; second, ask why margins had changed in the way that they had; and third, inquire if Members of Court thought the changes were for the good or the bad. Margins had risen considerably since the early 1970s, the bad old days when the end of capitalism had been frequently heralded. This was reflected also in the data on rates of return and profits. Mr King then went on to explain a table detailing manufacturing input prices, unit profits and output prices. He would leave to Court the question of why margins had increased since the 1970s and had not dipped in the latest recession by very much. As to whether the increases were a good thing, he noted that there might have been a need for margins to recover. First, in coming out of the recession, firms wanted to rebuild profitability. Second, export markets might have been constraining profits in the past. And third, profits were an important source of finance for the extra investment we wanted. But he wanted to ask Court this question: could the mixture of margins and volume have been different? Should firms have earned the same profits by producing more at a lower margin? Would this have given better results for the UK economy as a whole?

Sir David Lees protested that this was not the way that firms think. Business is going to go for margin in all circumstances. Business is in the best position to judge the split between margins and volume. The Governor accepted this, but still felt that there was a difference between the long-run and the short-run. He was not arguing that the economy had different requirements than businesses. Even for businesses, was it not sometimes better to get more volume rather than higher margin in the long run? Would not firms prefer this if they were assured of stable economies in the long run? The Deputy Governor argued that it was quite possible to have a small volume of production and very high margins and still end up with very low profits. Surely businesses did not want this? Sir Martin Jacomb said that what mattered was the demand that firms expected in the future. If they were assured of demand growth, then they would go for higher volumes. Otherwise they would want to maximise the price obtained on each unit sold. Sir Roland Smith noted that capacity had been taken out of British industry over the last few years. Industry was now short of capacity. Industry had a lower head-count now, and import prices were relatively low. But businesses do not yet have confidence that low inflation and reasonable profitability will persist, so they are not yet laying down more capacity. This meant that there were now capacity constraints in some areas of industry. This was a particular problem in areas requiring new technology, which was difficult to bring on stream quickly. Mr King thought that this augured well for inflation, because it implied that some of the increase in margins was temporary and would be reversed as firms' confidence grew and investment increased.

Under the weekly executive report:-

(i) The Governor said that for the previous 6 months, minutes had been prepared of his monthly meeting with the Chancellor. These had then been looked at six weeks after they had been written, to see how they would stand up to public scrutiny. The Chancellor and Prime Minister had decided that they would like to publish the minutes 6 weeks in arrears, in response to a suggestion from the Treasury Select Committee. Such a step will prove helpful to further the transparency of policy. The decision will be announced on 13 April, with the minutes of the meetings of January, February and March being published at that time. The Governor said that he saw this as a significant step forward for the Bank. It would enable our advice to be both explicit and transparent to the public. It was not without its dangers. For instance, February's minutes would reveal the difference in opinion that had taken place and, subsequently, which side had been right and which side had been wrong. The risks to the Bank would be no different to those we would face operating independently. For the Chancellor, the risks were different; it was a brave step for him to take especially if, for instance, he had overridden the Bank.

(ii) The Governor mentioned that when he had been in New York the previous week for bilateral meetings, the President of the Federal Reserve Bank of New York, William McDonough, had presented him with the letter Montagu Norman, when Deputy Governor, had written to Benjamin Strong in response to a letter from the latter. It was a very thoughtful gift and had prompted the Bank to consider arranging an exhibition of correspondence between the two.

E. A. George. [illegible]

Secretary. 7th April 1994

A MEETING OF DIRECTORS AT THE BANK

THURSDAY 31 MARCH 1994

Present

Edward Alan John George, Esq, Governor
Rupert Lascelles Pennant-Rea, Esq, Deputy Governor
Mervyn Allister King, Esq
Ian Plenderleith, Esq
Brian Quinn, Esq

The number of Directors assembled being insufficient to form a quorum, those present proceeded to the business, subject to ratification by the next Court.

The Minutes of the last Court, having been circulated, were noted.

Mr Plenderleith spoke about the foreign exchanges and the state of the domestic markets.

David Scholey

G. A. Croughton
Secretary 7th April 1994