A MEETING OF DIRECTORS AT THE BANK

WEDNESDAY 3 SEPTEMBER 1997

Present

Mr George, Governor

Mr Clark

Mr Foot

Mr Plenderleith

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 Meeting, having been circulated, were noted.

Mr Plenderleith spoke about the foreign exchanges, including the Official Reserves figures for August. Responding to a question from the Governor, he said that Treasury officials were still minded to recommend a policy for a lower level of net reserves held by the EEA, but the issue was in limbo and had not been raised with Ministers since the election. Ministers did, however, want to consider publishing more detail about the reserves: proposals on this were awaited. The Governor noted that any change of policy on the level of EEA reserves could have a bearing on the appropriate level of the Bank's own foreign exchange holdings.

16.9.97

A MEETING OF DIRECTORS AT THE BANK

WEDNESDAY 10 SEPTEMBER 1997

Present

Mr George, The Governor

Mr Clementi, The Deputy Governor

Mr Plenderleith

Mr Clark

The Governor welcomed Mr David Clementi, the Deputy Governor, to his first Meeting of Directors.

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 Meeting of 3 September, having been circulated, were noted.

Mr Plenderleith spoke briefly about the foreign exchanges and the domestic markets.

16.9.97

A COURT OF DIRECTORS AT THE BANK

TUESDAY 16 SEPTEMBER 1997

Present:

Mr George, Governor

Mr Clementi, Deputy Governor

Mr Allsopp

Mr Buxton

Mr Clark

Sir David Cooksey

Mr Foot

Mrs Heaton

Sir Chips Keswick

Mr King

Sir David Lees

Mr Plenderleith

Mr Simms

The Governor welcomed Mr Clementi to his first long Court and complimented him for fitting into the Bank so extraordinarily well in a short space of time. He also thanked Members for rearranging their diaries so that Court could be held a day earlier than usual.

Minutes

The Minutes of the Court of 20 August and the Meetings of 27 August, 3 and 10 September, having been circulated, were approved.

The Bank of England Bill - further developments (Messrs Footman and Berkowitz in attendance)

With reference to a Minute of Court of 20 August, the Governor outlined further progress on the Bill. He said the following papers had been placed in folders:

- The latest draft of the Bill, covering the MPC and Court (but not yet the transfer of supervision, statistics or the Bank's finances).
- The Treasury's latest draft of the Memorandum of Understanding, and the Governor's letter to the Chief Secretary proposing drafting changes.
- Records of his meeting with the Chief Secretary on 19 August and 4 September.

The Governor commented that the intention remained to introduce the Bill on 27 October or very shortly afterwards. If that deadline was missed, the Bill would become mixed with other legislation and could be delayed. The Bill must therefore be in a presentable state by 22 October. This was now likely to be achieved.

Turning to the provisions in the draft Bill covering Court, he said they were very much as they had been discussed at Court in August. The Bill provided that there should continue to be a Court of Directors, with a Governor, two Deputy Governors and sixteen Non-Executive Directors. Apart from the formulation of monetary policy, Court was to manage the Bank's affairs, including determining objectives and strategy. In that context, the Bill referred to ensuring "effective discharge of the Bank's functions" and "the most efficient use of the Bank's resources". As Court had already discussed, certain functions of Court were to be delegated to a Committee consisting of all the Non-Executive Directors, but with provision for them in turn to delegate further to sub-Committees.

The functions were: reviewing performance, monitoring the achievement of objectives, reviewing financial controls, and the remuneration of Governors. The chairman of the committee of Non-Executives would be designated by the Chancellor. He or she would also chair Court in the Governor's absence. Non-Executive Directors were to report separately in the Annual Report, on matters for which they were specifically responsible. Non-Executive Directors' remuneration would also be set by Court with the agreement of the Chancellor, and the Governor noted that it might be more than £500pa.

The Governor commented that where Court was concerned there were two issues remaining between the Bank and the Treasury. The first related to the purposes of the Bank. Only monetary policy was to be spelled out as a purpose in the Bill, as it stood. The Governor commented that it was arguable either way whether the other purposes should be referred to. He had in mind particularly the maintenance of financial stability and the third core purpose; (the encouragement of the efficiency of the financial system). Spelling out the other purposes of the Bank would be constraining, a view taken by some in the Treasury. On this view, it might be better to define the monetary policy purpose and leave all the others to be determined by Court. The Bank's position was that the other purposes should be referred to in the Bill, but they should not be made exclusive.

The second main issue was the terminology used to describe those appointed to Court. The Bank was very keen to retain the title of Executive Director for senior executives below the level of Governor. It had argued that the term "members" of Court, rather than "Directors" should be used to describe the Non-Executives. The Bank had however been assured by Treasury lawyers that even if Court members were described as "Directors" the Bank could still have Executive Directors who were not members of Court. So the issue was not critical. He invited Court's views.

Sir Chips Keswick commented that Court was given the responsibility to ensure the most efficient use of the Bank's resources, but he did not know what these resources were, and he asked whether Court would know by the time the Act was passed. The Governor replied that Court would know by then. There had been modest progress. The view of Treasury officials was that the capital of the Bank should be more or less as it was now. Ministers had accepted that rather than have the Bank's income dependent solely on the public purse, cash ratio deposits should remain. The Governor expected that the Bank's capital would be much the same, but its prospective income streams would be somewhat less than today to allow for the transfer of supervision and other functions. In response to a question from Sir Chips about whether the Bank would have a balance sheet, the Governor said the crucial element was the size of the Bank's capital, which would determine the size of its balance sheet. If the capital was as now, the balance sheet would not alter significantly.

Sir David Lees commented that the reference in the Bill to "Directors" as opposed to Non-Executive Directors was curious. The Governor and the two Deputy Governors were only Directors if they were collectively embraced as part of the Court of Directors. The use of Directors as opposed to Non-Executive

Directors was quite clearly supposed to exclude them. The second difficult word, he noted, was management. It was not normal to delegate management functions to Non-Executive Directors. They in turn would have to delegate the management function to Executive Directors or executives. A convoluted chain was created by the use of the word management.

Mr Berkowitz noted that management was the word used in the Charter and in the 1946 Act. It was an attempt to replicate the provision in a public limited company article of association that says the board has the powers to manage the company. Sir David Lees said that this was not a Court responsibility but was vested in a sub-committee of the Court, which was composed of the Non-Executive Directors.

Mr Berkowitz agreed that in Section 3(1) the phrase "management functions" was not a happy usage. The effect was to take the functions normally exercised by the board and give them to the Non-Executive Committee. Mr Footman said that they were not actually management functions: each started with the word "review". He advised removing the word management from the beginning of clause 3 and from 3(2). This was agreed.

Mr Berkowitz noted the confusion which appeared to imply that the Governor and the two Deputy Governors were not Directors. The term <u>Non-Executive</u> Member of Court would make the distinction clear. The Governor said he took it that Court would support this view. Sir David Lees said he believed that the description <u>Non-Executive Directors of Court</u> more accurately reflected their status. The Governor asked whether Court was concerned at the distinction between Non-Executive Directors and Non-Executive Members, and noted that as long as it was possible to use the description Executive Director, the Bank did not mind. Sir David Lees said he preferred Non-Executive Director of Court, but he did not mind much either way. Mr Buxton said he preferred the word "Director" because the more the impression was given that this was a board of directors the better it would be.

Mrs Heaton noted that the Chancellor designated a member of Court to chair the sub-committee, which she commented was very unusual. The Governor agreed but said that to an extent the arrangements were sui generis, given that there had to be a counterweight representing the interest of shareholders, since there was an executive chairman. This arrangement was perfectly acceptable to the Governor. Sir David Lees commented that the parallel would be if a board nominated a Non-Executive Deputy Chairman. But then it would not be the shareholder that would make the appointment, and he accepted that the motivation might be different. The Governor commented that the Bank could represent the view of the Court that Non-Executive Directors should make the selection, but he believed there would be resistance from the Chancellor. Mr Buxton said he believed objecting would be impractical and the Deputy Governor agreed. Court had more important matters to win. The Governor noted that, apart from these issues, the Bill was very much the same as when Court had discussed it in August.

Turning to the monetary policy section of the Bill, the Governor said clauses 7-15 followed very closely the terms of the Chancellor's letter of 6 May. The MPC was a committee of the Bank with responsibility for formulating monetary policy. It consisted of the three Governors, four appointments made directly by the Chancellor, and two appointments made by the Governor. The latter were now defined as "a person who has executive responsibility within the Bank for monetary policy analysis" and "a person who has executive responsibility within the Bank for monetary policy operations". Apart from the Governors, MPC members were employees of the Bank. The objectives were to maintain price stability and subject to that, support the economic policy of Her Majesty's Government, including its objectives for growth and employment. The Treasury was to inform the Bank annually what "price stability is to be taken to consist of" and "what the economic policy of HMG is to be taken to be". The Government thus set the target. Decisions of the MPC were to be announced "as soon as practicable" after each meeting and published within six weeks, including a record of the vote. There was also a requirement to publish a quarterly report "prepared by the Monetary Policy Committee". Court, through the committee of Non-Executive Directors, was to keep the procedures followed by the MPC under review, including the adequacy of regional and sectoral input. The Government also had an override power, defined in the text.

Turning to points still under debate with the Treasury in this area, the first was the precise definition of the role of the Bank and the role of the MPC in preparing the Inflation Report. There was provision that a report would be produced that would include a forecast of inflation. It might, however, be very difficult to obtain endorsement by the Committee of the precise terms of the Inflation Report, since it was very difficult to vote on a text. The position the Bank was taking was that the Inflation Report should be prepared by the Bank <u>in consultation with</u> the MPC. In substance, it was very important that the Bank received the MPC's endorsement of the Inflation Report, both text and forecast, but if it were to be a statutory requirement to make it a document of the MPC the Bank could foresee difficulty.

The second point was section 4(3) of the present Act, the power to direct bankers. The Treasury was minded to abolish this. The Bank might wish to propose an alternative, in case the MPC might wish to deploy monetary policy tools other than interest rates, such as special deposits or quantitative limits on bank credit. Under the proposal, the Bank would not have that power. Such actions would have to be recommended by the MPC and implemented by Government through some form of Parliamentary process.

The third issue was that the Bill proposed that the Committee, not the Bank, should have the power to remove members. This was referred to in Schedule 2(9). The Governor commented that the power should be in the Bank, that was to say Court. It seemed very odd that the Committee should decide to dismiss one of its own members. Otherwise the Bank was generally content with the monetary policy part of the Bill as it was coming out.

Mrs Heaton asked whether it was possible, with respect to powers to use tools other than interest rates, to allow the Bank's powers to be altered by delegated legislation, so they could be used in an emergency. The Governor said that the Bank could explore that issue. Mr Footman commented that that was how the clause giving the Bank powers of direction over "bankers" worked now. For the Bank to issue a direction, the Treasury had to bring the clause into force. It had not done so since 1946. One of the problems was that there was no definition of the word "bankers": that was for the Treasury to make. It was not therefore a power that the Bank could exercise freely. In response to a question from Sir Chips Keswick, Mr Footman said that the Bank was exempt from the Banking Act and that would remain the position.

Mr Allsopp commented that the requirement to review the regional and sectoral input to the MPC struck him as a trivialisation of the role of Court, and he proposed the words "other information" should be added. The Governor expressed sympathy with this point of view but noted that the governing clause was a preceding one, about reviewing the procedures of the MPC. He commented that the issue was perhaps that the Committee should collect the information necessary, including regional and sectoral information. He said the Bank would make that point. Mr Berkowitz noted that the wording was taken from the Chancellor's letter, and the Governor commented that that made the chances of achieving a change considerably lower.

Mr Simms asked for clarification of whether the work was simply to establish the MPC and carry out the other changes to the Bank, or whether it was tidying up parts of the existing Act after 50 years. Mr Footman noted that there were several aspects of the old legislation that the Bank was seeking to change. These included the use of the Seal, which was currently complex and time consuming. The Bank had asked for and achieved a more modern clause. Another was the declaration by Directors and Governors when taking office, which he was not sure would continue. There were the powers to direct, which Court had just discussed. There was also the power to request information from bankers. The advice was that the provisons in the 1946 Act could not sensibly be used. The Bank was addressing that by seeking an explicit power to obtain statistics.

Turning to the Bank's finances, the Governor said that some fairly radical proposals had now been put on one side. The important step for the Bank was the Chief Secretary's clear view, no doubt a reflection of that of the Chancellor, that the Bank should not be put on a financing basis where it was totally dependent on the Treasury. The outstanding issue was whether cash ratio deposits should be statutory or voluntary.

The danger of statutory cash ratio deposits was that the Treasury and Ministers would have to take an intrusive interest in the Bank's affairs as if the Bank were funded by Government. The impact of changes to the CRD would fall initially on the dividend and taxation paid to the Treasury. So one temptation, if it were in the hands of Government, might be to improve Government finances through the power to tax the banks. The Chief Secretary preferred a regime in which CRDs were, as now, on a basis agreed between the Bank and the commercial banks. But his preference was not revealed in the text of the minute of the meeting at which he expressed it. As the minute had taken 10 days to prepare, he suspected those with other views in the Treasury might still be arguing for a statutory basis for CRDs. The Chief Secretary had asked him to discover the attitude of the banks to this question, and enquiries had been made through the President of the British Bankers Association. Indications were that the banks preferred a voluntary arrangement, but that needed to be firmed up. In the light of that, and of the Chief Secretary's view, the Bank would prefer voluntary CRDs, while recognising that at some stage down the track the Bank might have a stand-off with the commercial banks. He recognised that the banks had an interest in how the Bank of England disposed of the income. In response to a question from Sir Chips Keswick, the Governor said that overseas banks would be included, as today. In principle, the building societies should be included, though it would be necessary to embark on a discussion if that were to happen. Mr Buxton said that the banks were expecting CRDs to continue. He believed that continuation would ultimately lead to pressure being put on the costs of the Bank of England. He believed that the question of whether CRDs should be statutory or not would raise the question of why they were not statutory in the first place. A lot of banks thought that they were. He hoped that foreign banks would follow the lead of the major British banks in supporting voluntary CRDs. The Governor said it was a sine qua non that the total of Bank and SIB costs (relating to bank supervision) was no more than at present, and the Bank would hope to be able to reduce its costs, and that would involve a further contraction. The Bank would continue to argue for a voluntary CRD arrangement and would keep Court informed.

The final major point was what had the Chancellor meant when he said the Bank would remain responsible for the stability of the financial system as a whole. That flowed through to the Memorandum of Understanding between the Bank, the SIB and the Treasury. There was no difficulty between the Bank and the SIB, which saw the divide in precisely the same terms. The bigger issue was a quite separate question of accountability for the potential use of public money. The Treasury view was that if any money was put at risk in terms of the Bank's operations, of any kind - not just propping up failing banks, but intervening in the settlement system - there was a question as to whether the Chancellor should approve each option ex-ante, because of the potential cost to the public purse.

On the other hand, there was a fear that in certain circumstances where a problem emerged very quickly, or as its nature changed during the day, the need for ex-ante approval would inhibit the Bank's ability to respond. In the initial draft the Treasury put an absolute limit on the amount of assets to be acquired. That did not recognise the range of activities the Bank was engaged in. If the Bank were buying gilts for liquidity purposes, it would not be the same as buying a rotten mortgage book. The Governor commented that in his view, the Chief Secretary understood the point. There was a move in the Treasury towards understanding that the Bank should have a degree of flexibility in this area and that it should be related to the risk undertaken. To make that work the Bank would have to ask Court's approval for attaching risk weights to different types of asset. So in a broad way, ex-ante, Court would have to oversee the different risks. But the Bank would still need to come to Court with particular cases, because there could be all the difference in the world between buying assets from one institution and from another. The Bank did not have a diversified book, so the risks would vary from one circumstance to another in a way not applying to the diversified portfolio of a commercial bank. The Governor also noted that the Bank favoured the proposal in the Bill for a standing committee. The Bank would in addition accept a commitment that to the extent practical it would inform the Treasury as far as possible before it took on a commitment, just as the Bank would tell Court.

In response to a question from Sir Chips Keswick, the Governor said the Bank always acted as good bankers, and took what security it could in return for lending. The difference between the Bank and a commercial bank was that the question of the Bank's intervention only arose in cases where lending was not a commercial proposition. Mr Buxton supported the idea of a standing committee but wondered whether monthly meetings were enough, because situations tended to come up very suddenly. Mr Buxton also said that it should be possible to build on the role of a risk management committee, which analysed the risks of particular situations and established limits. The Governor said that that was the structure the Bank was aiming to achieve. The issue in relation the Bank and the Treasury was how much discretion should be granted to the Bank. The position he had taken was that Court was fundamentally responsible for the capital resources of the Bank. The Bank was seeking to operate within the limits of the Bank's capital, of a little more than £1bn, subject to the oversight of Court. This had always been a fundamental role of Directors of the Bank. The Bank had proposed that Court would be responsible for the use of the capital, and it would agree with Court the risk parameters and the amount that executives could put at risk. The Bank should not put at risk in operations of this type, more than, say, 10% of the Bank's capital and reserves. It was difficult to put a precise limit because the amount of risk was to some degree dependent on the extent of the threat to systemic stability. If any significant amount of capital were at risk the matter would be taken back to Court. The Bank could agree with the Treasury that 10% of its capital could be put at risk, which was around £100mn, and within that the Bank would have the discretion to act. If it was necessary to go beyond that, the Bank would go back to the Treasury. The amount might exceed what the Bank expected in the first instance, and it would be important that the Treasury understood that. The Bank would always advise the Treasury in advance and if the Treasury said that the proposal was unwise that would have to be something Court would take into account. It would effectively give the Treasury a veto, in those cases where the Bank was able to inform them in advance.

Mr Buxton, agreeing, said the question facing Court was how effective were the Bank's risk management techniques. The Governor commented that risk management was a healthy discipline. The Deputy Governor commented that he had come from a bank that operated a risk asset model, and he believed the Bank required a more definitive risk asset model of its own. He also commented that the standing committee between the Bank, the SIB and the Treasury was a monthly set-piece meeting to which all those involved in the financial stability area of the Bank would work. Day to day contacts would be very much more frequent than monthly.

In response to a question by Mr Allsopp, the Governor said that if there were a loss it would ultimately be borne by the shareholder, but there were shock absorbers along the way. He gave, as an example, the small banks in the early 1990s where the Bank acted as lender of last resort, while making a provision. This was reviewed by the Court in the context of preparing the Bank's accounts and fed through to the tax and dividend payments to the Treasury. If losses were sufficiently severe, leading to negative net income, that would be a factor to be taken into account in determining the income stream of the Bank, including cash ratio deposits. Such a case would have implications for the banking system.

In reply to a further question from Mr Allsopp, the Governor said that the Bank did not have estimates of how much it might spend year by year in this way. On the basis of the discussions the Bank was having now, in a major financial crisis it would be for the Treasury to determine what to spend, and that would be public money. The issue under discussion was to what extent the Bank should be able to commit a part of its resources, represented by the Bank's capital. In other countries the scale of support activity had been enormous, amounting to as much as 5% or even 10% of gross domestic product. The Bank was not talking about that sort of number. It was consciously thinking of taking risks up to about 10% of its capital. That would enable it to support a medium-sized bank of the size of Barings or a number of smaller banks - as in the early 1990s - on its own balance sheet, while keeping the Treasury informed. Sir David Lees said he supported the Bank in this matter, in the light of the Bill, the changes in the composition of Court and the greater responsibilities given to Court. Otherwise it would lead to layers of second guessing. The Governor agreed that second guessing paralysed the process. The real risk was that the process became so bogged down that it was not possible to get agreement of all the parties, ex-ante, before the situation emerged into the public domain. Another point was that if Court was not given some responsibility for managing the Bank's financial affairs, including the use of capital and income, it was quite difficult to see what the senior people who were giving up their time to Court were going to be doing. The Governor believed he had the strongest board in the country. But if that was to continue he did not believe it was sufficient for members of Court to be there simply to confirm decisions by the Treasury. Sir David Cooksey commented that the Bill seemed to be more concerned with monetary policy, and he urged the Bank to continue to press for the inclusion of the other core purposes. The Governor thanked Sir David and said the Bank would continue to do so.

Mr Footman commented that there would need to be a new Charter at the same time as the new Act. The Bank was proposing to go to the Privy Council to ask that Court be given the power to amend the Charter. All that would be left of the Charter, after the Act, would be the incorporating clauses of William and Mary, because most of the business of Court would be shifted from the Charter to the Bill.

E-Money (Mr Footman in attendance)

Mr Clark introduced the paper on E-Money, which highlighted recent developments in electronic money products, considered both the domestic and international issues they raised and questioned whether there was a need for regulation. He commented that there was no satisfactorily clear line between what had to be regulated and what should not be regulated. This led to difficulties for those firms setting up e-money projects, and confusion for consumers using them, including the extent to which they were covered by deposit protection arrangements.

A second question was whether the line between regulated and un-regulated products was in the right place, which he saw as a decision for Government. There was a trade-off between the risk consumers took on and the hope that competition would not be inhibited. Mr Footman commented that the legislation was a mess, and it was necessary to clarify it. It was not clear that non-bank e-money would be regulated at all, and certainly it would not be covered by deposit protection. People holding e-money may assume they had protection: that was not the case. There was much scope for confusion and disagreement if an e-money scheme failed. Mr Footman noted that the Continental Europeans were pressing for regulation of e-money on a fairly large scale. Quite a lot of central banks would like e-money restricted to banks. The Bank of England's view was that at present e-money was relatively small scale, so macro-economic worries about the extent to which e-money displaced cash and about the interpretation of the monetary aggregates and even the possible effect on the operating capacity of a European central bank, need not be of concern. The immediate question was consumer protection. The European Commission had drawn up draft legislation for discussion later this year. The Treasury's reaction at official level had been to consider ways of delaying or watering down the proposals, but Mr Footman did not believe that Ministers had yet been consulted.

Ministers would have to take a decision in the light of the European draft directive. It would be considered in the UK presidency, but the Government had indicated that it would prefer this to be kicked off into the long grass for the moment, implying it would probably be considered under the following presidency of Austria. The Bank was neutral, in that it did not see a strong case for regulation. But in taking that line it was, among European central banks, in a minority of one.

Sir David Cooksey commented that a number of London bus operations and some local authorities were considering e-money schemes, and that there was a pilot scheme in two local authorities. It was well known that local authorities had been in trouble in the past for exceeding their powers and the issue needed a close watch to ensure that schemes did not go out of control. The Governor said that his overriding concern was that the public should know precisely what it was being offered. He was not enthusiastic about regulation ab initio, but if there were not to be regulation the public should be made aware of the fact, so that if there were a problem there would not be complaints that people did not know.

The Executive Report

The Deputy Governor, commenting on his appointment and role, said that he was delighted to be at the Bank and he thanked the Governor for his kind words earlier in the meeting. He had read in the Minutes of the last meeting that his appointment had been described as inelegant, and he understood that that was not directed at himself but was a remark about the process. The Government was aware of the Court's views and it was best that the matter was left there. Mr Clementi said that he had been very warmly welcomed at the Bank.

There were three areas of responsibility which he expected to come back to Court to discuss over the next few months. The first was the transfer of Supervision & Surveillance, with a substantial number of staff moving to NewRO. This would have an impact on the residual Bank. There were opportunities to slim down to one location and real benefits would be achieved when that happened, but the process was not straightforward.

Secondly, there were the preparations for a single market, overseen by EuroCo, the Committee responsible for ensuring that the Bank itself would be ready by 1 January 1999. The latest review had suggested that it had started slipping on one or two of the projects concerned, which was understandable because some were undertaken on the basis that Britain would join the single currency. But it was wrong to pre-empt a decision by the British Government, and it was critically important that the Bank was ready. There would be headlines if it were not, and it would be regarded as serious for both the country and the Bank.

Third, the Deputy Governor said he was looking at the internal controls of the Bank, a subject Court had tackled regularly. He was spending time with the internal and external auditors and with the Audit Committee.

Finally, the Deputy Governor reminded Non-Executive Directors that pages from the condolence book for Diana, Princess of Wales, would be available for signature in the Ante-Room, after Court. There were 500 signatures in the book and so far £8,800 had been collected for the fund. He confirmed that the Bank proposed to match contributions made by staff and pensioners to the fund.

Mr Foot announced the appointment of Mr Ronnie Baird, from Lloyds TSB, as Head of Quality Assurance in S&S with effect from 22 September.

The Governor drew Court's attention to the fact that Mr Foot's involvement in the restructuring of the SIB was increasing, though his contract gave exclusive rights to his services to the Bank. The Governor noted that Mr Foot was full time at both the Bank and the SIB, and he said that he took it that this was with Court's approval. It was certainly with his own approval. Bank interests were served by what Mr Foot was doing for SIB. He had agreed with Mr Davies that there would be no remuneration for what Mr Foot was doing for the SIB at the moment.

Mr Plenderleith advised Court that Peter Ironmonger was handing over to Geoff Sparkes as Chief Registrar at Gloucester that week, on Mr Ironmonger's retirement.

He also advised Court that a court case would start next week on the theft of banknotes from Issue Office and it was believed that the accused may plead not guilty and may implicate a colleague. He warned Court that there may be some publicity.

Mr Clark commented on changes at British Invisibles. First, the concerns of the Corporation had been resolved about the treatment of existing staff in the new structure. Second, a new Chief Executive, Jeremy Seddon, had been appointed from BZW. Third, British Invisibles had endorsed a merger proposal, and this had been sent to BI members and to the Corporation's Policy and Resources Committee. Fourth, it was hoped that it would be signed by both sides in October and the new body would be launched in early November. Douglas Hurd, who had chaired the original Committee, had agreed to chair the new body. The Governor said that the time it took to see through the new arrangements had been well spent. He was hopeful that with Douglas Hurd and Jeremy Seddon and with the drawing together of City efforts with British Invisibles there would be a more coherent vehicle for the promotion of the services of the City.

Economic and Monetary discussion, including Market Charts (Dr Julius and Professor Buiter in attendance)

The Governor introduced Dr DeAnne Julius, who was attending Court for the first time. Mr King commented that at the August meeting the Monetary Policy Committee had raised interest rates by ¼% to 7%, in order to hit the inflation target. The MPC made clear that it had reached a position where it was necessary to pause to assess the risks to inflation. The Committee discussed estimates of growth, pressures on the labour market and the money numbers. There was a lengthy discussion about the implications of the fact that broad money was still growing between 11% and 12% a year, which had been a puzzle for more than a year. It was still the case that this growth was concentrated among other financial institutions and not in the sectors responsible for the spending. The Committee had not found a simple answer to this. The real question was whether it would lead money to flow to the corporate and household sectors, which would lead to more spending and inflationary pressures, or whether it would lead to the repayment of debt in which case monetary growth would fall. The conclusion was that the risks were less to the extent that growth was in other financial institutions rather than in the household and corporate sectors.

Mr King noted that the MPC commissioned a survey by Market and Opinion Research International of consumers' attitudes to windfall gains, based on what they had actually done, not what they planned to do. Finally, there was a discussion of the impact of sterling on net trade, and the behaviour of the exchange rate. The puzzle was that business surveys were looking towards a sharp impact on net trade, but the trade data were showing no sign of it. Possible explanations were the quality of the data or the fact that many manufacturers were not convinced that the rise in sterling would persist. The MPC had concluded that the dilemma was if anything more acute, and that a further rise in interest rates was required to hit the target. But if rates were set to be consistent with the target, making that clear might bring sterling down a little. He noted the effect of the words in the interest rate announcement on 7 August in bringing down the exchange rate.

Turning to the tables and charts, Mr King noted that activity was not growing quite as rapidly as had been thought. But the dilemma had, if anything, increased. The exchange rate had been the heart of the dilemma over the past year, with the effective rate increasing very sharply although it had fallen last month. In the past month there had been no change against the dollar but a significant change against the deutschemark and the exchange rate index. The pound was down 5% to 6%

against the deutschemark in a month, and this did help ease the dilemma. Referring to the MPC press release on 7 August, Mr King noted that the effect on the exchange rate had appeared to persist. The cause of the fall at the time was the MPC statement that there could be a pause, which had lowered the yield curve, bringing the exchange rate down. However, the yield curve was now back up while the exchange rate was not, so something else was going on.

The MORI survey had shown that economists had not underestimated the impact of the windfalls on consumption. Mr King noted that the Bank's estimates were at the lower end of the range and the MORI survey showed that the impact was, if anything, less than the figure in the Bank's projections in the August Inflation Report. It was reassuring that the upside risks of higher spending might not be as great as had been feared. The MORI results were also consistent with earlier surveys and with the Bank's analysis, and went against earlier scare stories about a boom. It was however possible that spending might be more concentrated, within a shorter period of two to three months. Much of the spending might not be retail, and could for example be on cars or on foreign holidays.

Finally, the MPC had considered whether means other than a rise in interest rates could be used to resolve the Bank's dilemma. There were three possible instruments: special deposits; changes in debt management, towards overfunding; and foreign exchange intervention. The MPC considered a paper by Bank staff on special deposits, which concluded that they were unlikely to be effective and would fall most heavily on small businesses and on individuals. They would provide a serious disincentive, would be inefficient and unlikely to be effective. The MPC agreed with these conclusions.

Turning to overfunding, which would restrain monetary growth, the Committee was not confident that such a change would contribute usefully to addressing the policy dilemma.

The Committee finally discussed the possible merits of intervention in the foreign exchange markets. There was a consensus that intervention was worth contemplating, but only if it was accompanied by credible actions to put the economy on a course consistent with the inflation target. In those circumstances, it could help to bring about an adjustment in the exchange rate, which might otherwise be more protracted.

Commenting on the markets, Mr Plenderleith said that whenever he saw the date 16 September he recalled with a *frisson* the events of five years ago. He commented that it was rather bizarre that with the appreciation of sterling the currency was back to almost the same effective level as the day Britain left the exchange rate mechanism five years ago. He described this as a coincidence. Mr Plenderleith noted that sterling peaked after the August meeting of the MPC and the effective rate had fallen by 5%, though happily it was not plummeting too ferociously. He commented that the market saw three main factors. The first was an indication from the MPC and the Inflation Report that the Committee felt the level of interest rates was adequate for the moment to deliver the target rate of inflation, implying a pause. On balance, the market expected more interest rate rises later this year or early next year, but saw a peak for the moment.

Secondly there was a sense that things were changing in Germany, where there was a gradual pick up in the economy and incipient inflationary pressure, bringing a likelihood of

German rates rising. That remained a possibility. Thirdly, the markets felt that sterling had overshot in the summer.

The Governor invited comments from Members of Court. Mr Buxton commented that it was true that manufacturing had not softened to the extent that earlier in the year the CBI, amongst others, had felt would happen. But export orders were definitely down and sooner or later that was going to come through in output. There were signs that output was softening, but not as dramatically as had originally been thought. Car sales in August were very high, and these were outside the retail figures. The distributive trades figures were all over the place, and though they appeared to have softened, it was not possible to say that this had definitely happened. He concluded that it was right both to raise interest rates and then to pause, and he suspected that the pressures were still upwards rather than downwards on inflation. Mr Buxton also noted the large amount of money going into PEPs.

Mr Simms commented that the construction industry had been stronger for some time. Workloads had increased in the last twelve months, but the three month statistics showed a significant fall. He was not sure whether the election effect had been eliminated completely. He had no doubt that it was all being driven by private sector spending, while public sector spending was in the doldrums. Mr Simms noted that profitability was very low indeed. Labour pressures were still felt only in London and the South East where there were quite considerable shortages now, though there was no real evidence that this was spreading further afield. Mr Simms also urged the Bank to make full use of the construction industry's data in its model. Mr King commented that the absence of a reference to this data in the documents shown to Court was because it had been decided to show surveys that demonstrated weakness, and construction industry results had certainly been taken into account in the Inflation Report.

Sir David Lees said that he believed that hard won exports were not being given up easily by the manufacturing sector. Companies were hanging on, despite rotten margins. They were playing out their foreign exchange cover contracts. He suspected that the way the pound had been moving during the last few weeks might be changing some manufacturers' minds about how quickly they should give up. With domestic output quite strong, he did not think manufacturers on the whole would give up easily, though with sterling where it had been a number of manufacturers might have been forced to do so.

Mr Allsopp congratulated the MPC on its news management, with which he said he was very impressed. He asked whether there was ever a case for not pushing interest rates to the point where people perceived the probability of going up was equal to the probability of going down. Mr King noted that the MPC planned a full day discussion on this issue. There were some circumstances where particular types of uncertainty implied not going all the way. The argument against going all the way was that there were certain kinds of uncertainty where such a move could lead to a substantial reversal, and that could inject volatility into the economy. There was a trade-off. A lot would hinge on the costs and benefits of reversals of interest rate movements and the impact on economic behaviour.

Mr King noted a second question, which was whether targets should be set against the median interest rate or the expected interest rate. How was it to be defined? That was also a question to which the MPC would wish to return.

Mr Plenderleith noted that the Bank had been operating in circumstances in which there was an exchange rate dilemma. The MPC had to consider the tactical question of whether small or large steps would have a greater impact on the exchange rate. Dr Julius said there was an issue of decision theory. Discussions could become too focused on the model and the probability distribution. Interest rates would be tweaked month by month, with the aim of ending exactly where the model predicted they should be. However, that would constrain discussions to factors that could be fed into the model, and there was a need to take account of wider ranges of views. Mr Allsopp noted that gradualism was very fashionable among other central banks. He was concerned that might lead to expectations in the exchange rate market. He was hoping that the MPC would discuss this issue rather fully, and not necessarily follow standard central banking practice.

Professor Buiter said the question of gradual against large movements was not quite the same as the question of whether rates should be set at a level that, if kept constant, would hit a target with a probability of plus or minus 50% either side. There might be some sensible interest rate strategy, not necessarily a constant one, that might get the MPC where it wanted to be. Everyone agreed that the MPC should be cautious. But caution did not necessarily equal gradualism. The cautious way to jump over a hole was to take a big leap.

The Governor commented that the crucial concern for him was the credibility of the step taken. It was possible to have a view but it was necessary to take account of the tactical condition of the market. This was the reason why the August announcement had been so successful. It was plausible to the market, since the MPC had reached the point where it could in fact pause.

Mr King commented that if the factor that impacted on behaviour was not just short term official interest rates but the yield over two years, even if the short rate moved gradually, the yield curve could move like a random walk. The intellectual case for gradualism was not one that the MPC would automatically accept and it would be investigated.

He also noted that insofar as windfalls were used for spending on foreign holidays they were not adding to UK inflationary pressures. On exports, the MPC's belief was that the lack of response to the level of sterling was a result of firms adjusting prices and margins to maintain market share. The crucial thing about the August meeting was that the MPC felt it had come to the point where, if the exchange rate had continued at a high level, then firms may have had to adjust volumes. The fall in sterling which had just been seen may raise doubts in the minds of manufacturers and may encourage them to keep going on a bit further. So far, the MPC had not seen the impact of a higher exchange rate on net trade and there must be some uncertainty about when that would come through. Mr Buxton said the statistics on order expectations were quite well down. Orders were dropping off which implied sooner or later that there would be a drop in output. The Governor noted that that was built into expectations, because the Inflation Report showed quite a sharp deterioration.

Professor Buiter asked whether the fall in orders was mainly a result of firms staying in markets and simply supplying less, or whether they were withdrawing, which was a very much harder process to reverse. Mr Buxton said he would have thought that firms would try very hard to stay. He did not think they would withdraw until they were really up against it.

International Economy - IMF meetings (Mr Drage in attendance)

Mr King commented that there had been a great deal of financial turbulence in the Far East. The theme of the annual meetings of the International Monetary Fund and the World Bank would be dominated by recent events. These included the new lessons learnt from Thailand. Questions included the nature of the contagion, was the market response a natural one, was it fuelled by the initial reaction of the Thai authorities, and by the statements in other countries, what was meant by systemic stability in these circumstances and what should be the reaction of international financial institutions. Was there a shift to a more regional support system or did we still have a multi-lateral financial system?

There was no specific question about Thailand on the IMF agenda, but these wider issues would feature in discussions. As for Thailand itself, the problems were not necessarily over. It was a good example of the linkages between monetary and financial stability, which was an issue that would certainly be discussed.

The other items to be discussed at the formal meetings in Hong Kong included an issue of SDRs, partly to deal with the problem of inequity among new members of the fund and an increase in the quotas of the IMF, about which Mr King was hopeful but not confident, because the US had not yet revealed its position. There was also the issue of changes to the articles of the IMF to include capital account liberalisation, on which slow but steady progress was being made. Finally there was the NAB (New Arrangement to Borrow), which was broader than the G10. The NAB had not yet been approved formally by all parliaments, but there would be a lunch in Hong Kong and a meeting to exchange views.

Sir Chips Keswick asked whether credit rating agencies and their effect on world capital flows were on the agenda in Hong Kong. Until there was some correlation between public and private agencies he did not think there could be a lot of progress in dealing with emerging markets. South Africa had a domestic triple A rating, but for international agencies it was hardly investment grade. Until there was more cohesion between agencies and the IMF as to what was credit-worthy as a nation, Sir Chips did not see full credit facilities being available to emerging markets. Mr Buxton asked how far the Bank would get involved in World Trade Organisations financial services deregulation issues. He noted that the Chancellor would be commenting on the need for greater openness in trade in financial services. The Governor said the Bank had been in discussions about financial market liberalisation, but not directly in the trade negotiations. It was involved indirectly through its input to the British Government position.
Mr Allsopp commented that the world economic outlook showed an extraordinarily rosy picture of a world continuing to grow. But there was an increasing sense of risk. He was concerned that growth could start to unravel, because of the extent to which it was influenced by South East Asia and other emerging markets. These countries were having to make a large domestic adjustment that could inhibit European and Japanese recovery. He asked where exports from Japan and Europe would go. He saw a significant downside risk as a result of the Asian problems. Mr King commented that the IMF forecasts were point estimates which tended to give a rosy scenario. He would prefer the IMF to focus on risks. The IMF regarded the US and UK as likely to slow, and would see that as a good thing. He agreed that the

IMF did have a pretty optimistic scenario and had not really portrayed much of the risk posed to the US and Europe. One risk the IMF had not explored much was the very adverse developments in the financial systems of some of the South East Asian countries. That was a major risk in Thailand.

Sir David Lees asked for confirmation that South East Asia was not having a contagion impact on banks in the UK. He also said that the IMF's warnings about the need for labour flexibility in the European Union were spine chilling. Mr Foot said that the Bank had made regular checks in recent weeks with the major trading banks with involvement in South East Asia. There was remarkably little risk in terms of loss, and quite a few had made money out of volatility. The problems in Thailand were mainly in the domestic banking scene, and Hong Kong and China were very much less affected. Japan was undoubtedly an area the Bank was concerned about and it was monitoring closely Japanese exposures in Thailand and talking to Japanese banks when they came to London. Korea was another area where banks keeled over at regular intervals, and the Ministry of Finance was closely involved. The one thing that would change the picture in a particularly worrying way would be the failure of a highly geared entrepreneurial company in that part of the world. He was keen to hear any rumours that were circulating. The Bank had investigated one or two rumours but had found nothing.

Mr King, answering Sir David Lees' second question, said the IMF was pointing to issues that the Bank and most people outside Europe had pointed to as well. A measure of real convergence was needed to avoid EMU giving real difficulties. It had not been widely noticed that the stability and growth pact implied deficits on average of zero, so that 3% was the maximum during recession. That implied that fiscal consolidation would have to continue after monetary union. EMU had been portrayed as a source of job gains and reductions in unemployment, when in fact it could exacerbate the problem. The Governor noted that the OECD did most of the work in this area. If Sir David Lees was interested the Bank could provide him with some of their analysis.

Mr Allsopp said that in Europe the external surplus was heading towards Japanese levels. Japan was in surplus. If adjustment in South East Asia led to a balance of payments surplus there, too, it would not add up unless the US ran a high balance of payments deficit, and the US did not want to do that. What it came back to was the European recovery. If it was possible to get investment higher, the golden scenario would come through. If that started to unwind, the golden scenario would look very much more difficult.

The Governor thanked Court, and the meeting ended.

15.10.97

15.10.9

A MEETING OF DIRECTORS AT THE BANK

WEDNESDAY 24 SEPTEMBER 1997

Present

Mr Clementi, Deputy Governor

Mr Clark

Mr Foot

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

15. 10. 97

15.10.9

A MEETING OF DIRECTORS AT THE BANK

WEDNESDAY 1 OCTOBER 1997

Present

Mr George, Governor

Mr Clementi, Deputy Governor

Mr Foot

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 Meeting, having been circulated, were noted.

15.10.97

15.10.97

A MEETING OF DIRECTORS AT THE BANK

WEDNESDAY 8 OCTOBER 1997

Present

Mr George, Governor

Mr Clementi, Deputy Governor

Mr Clark

Mr Foot

Mr Plenderleith

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 Meeting, having been circulated, were noted.

Mr Plenderleith spoke about the Official Reserves figures for September.

15.10.97

15.10.97

A COURT OF DIRECTORS AT THE BANK

WEDNESDAY 15 OCTOBER 1997

Present:

Mr George, Governor

Mr Clementi, Deputy Governor

Mr Allsopp

Mr Buxton

Mr Clark

Sir David Cooksey

Mr Foot

Mrs Heaton

Sir Chips Keswick

Mr King

Sir David Lees

Dame Sheila Masters

Mr Neill

Mr Plenderleith

Sir David Scholey

Mr Simms

Sir Colin Southgate

The Minutes of the Court of 16 September and the Meetings of 24 September, 1 and 8 October, having been circulated, were approved.

The Bank of England Bill and Memorandum of Understanding (Messrs Footman, Berkowitz and Midgley in attendance)

With reference to a Minute of Court of 16 September, the Governor commented that the documents Court had before it - the Bill, correspondence between Alistair Darling and the Bank, and the Memorandum of Understanding - represented a sudden melting of the glacier in negotiations between the Bank and the Treasury. While he felt unable to do more than speculate about why this had happened so suddenly, he suggested that one possibility was the realisation that the timetable for the Bill was extremely tight.

The previous draft of the Memorandum of Understanding was unsatisfactory in three respects, relating to the paragraph covering the Bank's responsibilities, the paragraph covering the SIB's responsibilities and the role of the Bank in the procedures for managing a crisis. There was a reluctance to recognise the Bank's role in undertaking financial operations during a crisis, by acting as lender of last resort. Without some clear reference to that in the description of the Bank's responsibilities, the subsequent discussion of the relationship between the Bank and the SIB was confused, and implied that the SIB was managing the Bank's balance sheet.

It was also unsatisfactory in a more fundamental way. The Bank's role as lender of last resort was a determining characteristic of central banking and it was a puzzle why the Treasury had been so nervous about incorporating this in the MOU. However, in the final text there was a clear recognition that the Bank continued to have that role. The text reproduced the Chancellor's original statement that the Bank would have responsibility for the overall stability of the financial system and it acknowledged the Bank's role in official financial operations. That resolved the question of the dividing line between the Bank and the SIB in a way that was entirely satisfactory, the Governor commented. Paragraph 2 of the MOU gave the Bank firmer ground on which to stand than before, because financial stability had never been defined as fully. There was also a clear recognition of the Bank's third core purpose.

The Governor noted that the other issue which had been resolved was the capacity of the Bank to operate in emergency situations without ex ante approval by the Treasury for the detail of every operation it undertook. The Bank would be using Government credit, so it had to be accountable and responsible, and the Bank had always accepted that, beyond the risks appropriate to its balance sheet, it would need Government's explicit approval and formal guarantee. On the other hand, there was a risk that the Bank would be paralysed and not able to act. The original draft, at the end of September, had contained bureaucratic procedures, with a standing committee which would record the views expressed and then take a decision. This would have been a problem, in view of the situations the Bank was confronted with from time to time.

The Memorandum, as now drafted, included a standing committee that met regularly to discuss systemic issues. The committee could, from time to time, be called into urgent session. In emergencies, it would always be necessary to tell the Treasury about the Bank's involvement. The MOU acknowledged that the Bank could explore the problem, in conjunction with the SIB, and that it would keep the Treasury informed to the extent that the circumstances in a particular case allowed. The Governor commented that this was a realistic reconciliation of the need for public accountability on the one hand and operational flexibility on the other. He said he could recommend the arrangements to Court in a way that he could not have done with the 25 September draft of the MOU. The Governor invited comments.

Sir David Lees asked whether, in a rapidly emerging crisis where speed was essential, Court could take the decision on the amount of the Bank's balance sheet that could be committed? The Governor said this was the case. The Bank would bring to Court proposals on the assessment of the risk of different types of asset it might acquire in such situations. In reply to a question from Mrs Heaton about how the new proposals would have affected the Barings situation, the Governor said Barings would have gone to the SIB which would immediately have told the Bank that there was a major problem, that there could be systemic implications and that it could involve a decision to give official support. If there was a possibility of a commercial solution, the SIB and the Bank would jointly chair the meetings. But if it was clearly not a systemic issue and a commercial solution sufficed, the SIB would have taken the lead. There might be cases which were clearly not systemic, but nevertheless the SIB would be seeking a market solution. If there was any suggestion that a case was systemic and, at the end of the day, it might be necessary to use Government credit, that would have to be done jointly. The Governor commented that he would not want to do that before having explored private sector solutions.

Sir David Scholey noted that the system depended as much on co-ordination and contacts between the two organisations as when they were both in the Bank. The Governor agreed, noting that it was perfectly true that there could be tension. The regulator may, more naturally than the central bank, think that a particular institution should be supported. If the central bank did not agree support, the SIB could make representations to ask the Treasury to undertake it. The Governor commented that he had not experienced such potential conflict.

Mr Buxton asked whether it was possible to agree maximum limits on risks with the Treasury. The Governor replied that the Treasury had acknowledged the need for a degree of flexibility and wanted to set a limit on the quantity of assets to be employed by the Bank in support operations. The Bank had said this was unrealistic because the risks of different assets varied. The Bank had proposed instead that there should be an assessment of the risks of different assets taken on to its balance sheet. That was difficult for the Treasury to accept and the outcome of the discussion was the procedure in the MOU. In an emergency, the Bank could operate within limits set by Court, subject to the Chancellor effectively having a veto, and also subject to the Bank keeping the Treasury informed as the circumstances allowed. Sir David Lees asked whether, because the Chancellor had a veto, this meant in practice that Court would be making a recommendation that the Bank should become involved up to a financial limit. The Governor commented that there was greater flexibility than implied by Sir David. It was not quite the case that the Bank would make a proposal and the Chancellor could veto or approve it. In such situations, the Chancellor had the opportunity to express a view about the principle of whether the Bank should offer support and it was for Court to express a view on the implications for the Bank's balance sheet. Sir David Lees commented that paragraph 13 appeared to mean that the Bank could not commit support without at least giving the Chancellor, in the first instance, the option of refusing it. The Governor replied that it should be read as a whole, including the sentence "thereafter they would keep it informed of the developing situation, as far as circumstances allowed".

Mrs Heaton commented that there would continue to be within Government a schizophrenia between the need to know, so as not to be caught out, and a desire not to be held responsible. Mr Buxton commented that the arrangements would give Court a great deal more responsibility on the risk side than it originally thought it would have, because the Treasury would be very much more restrictive. It was a good thing to have some sort of limit below which the Bank would have complete authority. The Governor replied that he had some sympathy with that view. He would like to approach it by first producing, for Court to consider, an attempt to set the parameters for risk operations. If Court could discuss the implications of the kind of interventions the Bank might want to undertake, the Bank might then share the results with the Treasury. If the case at issue was not one that had to be resolved before the opening of the markets on the next day, whatever the size of operation required, the Bank would keep the Treasury informed. Mr Allsopp commented that it would be unwise to pin down the clause in the MOU too precisely. It gave a certain degree of freedom while people made their minds up. If the Bank tried for complete freedom it would open a can of worms again. The Governor agreed. Mr Buxton said he did not mean to incorporate his point in the MOU, but that he wished that the practice would grow up in that way. The Governor noted that he would share that thinking with the Treasury.

The Deputy Governor said the reality of the position was that the Bank would tell the Treasury if it intended to take a certain action together with the timetable involved. The Treasury had the right to exercise its veto. If the Treasury had not come back to the Bank by the specified time, the Bank would proceed with the relevant action. Sir David Lees agreed, underlining the point that it was still necessary to go through the motion of telling the Chancellor before something was done, though he may not have much time to think about it and would not have perfect information. The Governor noted that that was the de facto situation now, and the MOU replicated it. There were no further comments on the MOU.

The Governor said that, at the last discussion with Court, it had been suggested that the Bill should make reference to the purposes of the Bank. The Bill before Court only talked about the responsibilities of the Bank in the context of monetary policy. When the proposal to include the purposes of the Bank was put to the Treasury, officials wanted an exclusive list of the powers of the Bank, rather than the all embracing three-core purposes. It became clear that this would be constraining rather facilitating. This led to the conclusion that it was better to leave the general language of the Charter. The role of the Court under the Charter, and under the Bill, was setting the objectives and strategy for the Bank. The Governor commented that this was much more satisfactory than having a constraining clause in the Bill. Mr Berkowitz commented that the clauses, if they had been in the Bill, would have been constricting, because the Bank would have been constantly looking at its powers to see whether it could do things. The Governor noted that the Chief Secretary had stepped back from that position in his letter of 10 October.

The Governor also noted that the Treasury had two powers. The power of direction, which had always been there, remained in the Bill. The other power was for the Treasury to constrain the Bank's resources. The Bank was owned by the Government and it was right that, at the end of the day, the elected Government should have that kind of power. The Governor welcomed the statement in Mr Darling's letter on the finances of the Bank in which he repeated the clause in the Bill that Court was responsible for managing the affairs of the Bank including the

Bank's objectives and strategy. The important thing was that within that power, Court had an established locus.

Turning to the Bank's finances, the Governor commented that the prospects had been looking bleak until quite recently. The opening proposition from the Treasury was that it should control the Bank's expenditure. The Governor said he believed that the Chief Secretary rapidly accepted that this would be unwise. It would mean that the central bank would be funded out of public sector revenues. The Governor also noted the discussion about whether cash ratio deposits should be statutory or voluntary. The British Bankers Association was consulted by the Bank, and indicated that it preferred voluntary CRDs, though elements within the BBA indicated that they wanted the Building Societies included and some wanted other financial institutions, not all of them deposit-taking. The Governor questioned whether this could have been achieved on a voluntary basis. It was already clear that the Bank would be subject to more scrutiny by both banks and Government as to the size of the tax it was imposing on the banks. In these circumstances Mr Darling and the Governor had both felt statutory CRDs were to be preferred.

The Treasury had also proposed that, if it could not control the Bank's expenditure by giving an allowance out of the public purse, it would control the Bank by setting its dividend. If the Treasury set the dividend as well as the CRDs, it would control not just the Bank's expenditure but its capital as well. In the end, the Treasury accepted the existing dividend formula of distributing 50% of the Bank's post-tax profits unless there were agreement between the Court and the Chancellor on another sum. The Governor commented that this was the best situation the Bank could have wished to achieve.

Sir David Cooksey said that he was very concerned about the proposal to publish the Bank's budget. If a business was managed efficiently, the matching of budget and expenditure each year would vary. He believed that the Bank was opening itself to derogatory comments in the future, as a result of not meeting budgets. He was perfectly happy with the publication of medium-term planning but to publish the year-by-year planning was a very bad move. Dame Sheila Masters commented that there was no precedent for a public corporation to publish its budget, and it was certainly not done in the private sector. The Governor commented that there would, on the other hand, be a great deal of criticism if the Bank did not publish its budget. In reply to a question from Sir David Lees, Mr Midgley said that the published budget figures would not give away financial transactions such as support operations and provisions. In reply to a comment by Dame Sheila that the budgets would not align with the financial statements, Mr Midgley said that, within the public sector, what was meant by budgets was planned costs. The Treasury wanted the Bank to have a degree of public sector accountability, as was seen elsewhere in the public sector. He also noted that the Bank's practice was consistent with the work by Andrew Likierman and was ahead of the rest of the public sector in that respect.

In reply to a question from Sir David Lees, the Governor commented that it was right that the word budget should be reviewed and that it should be spelt out more clearly what the Bank was to publish. The words of the letter implied private sector budgeting rather than public sector. Mr Simms commented that the private sector did not publish budgets but gave very general indications of what it was likely to spend. The Governor commented that it was not right to take the private sector paradigm. The letter was about a spending budget and he believed that it was necessary to define what was meant rather more clearly.

Sir Chips Keswick commented that the use of target return on capital was not very sensible. The Governor replied that the Bank had to justify the dividend to the Treasury. But he agreed that it was possible to look at the language.
Dame Sheila Masters commented that return on capital was developed for industries investing in real assets and it was not expected that it should apply to a financial business - for example it had never applied to Girobank. It was a question of language, and without knowing the definition of return on capital, it was hard to know whether she agreed with it.
Mr King commented that it was neither the rate of return that was used in the public sector nor the rate of return in the private sector. It was more a question of investment strategy than a rate of return. Sir David Lees commented that it was more like a planning number than a target. Sir Chips Keswick suggested that it could be called a benchmark rate on Government funds. Mr Midgley said that such language was getting closer, but could get the Bank into difficulties in discussions with the Treasury, which did not accept that the Bank should be set a benchmark rate of return based on the return on government funds. The Governor noted that it was necessary to find a better way to describe it. Mr Midgley said that a benchmark rate of return was acceptable for the investment in financial assets, but there would be a difficulty in that £330mn of the pool of assets was fixed assets, largely property. The discussion would end up with a composite of a benchmark rate of return on Government funds and a target rate of return on fixed assets.

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The Governor said that part of the purpose of the rate of return was to establish the level of cash ratio deposits. It was a two-way thing. The Governor said it stopped the use of CRDs as a tax and it also set a floor to the rate by showing that the return to the Government was dependent on the relationship between the Bank's expenditure and the rate of the tax. The rate of return was not designed to deliver the Bank's investment strategy. However, the Governor said that he believed the identification of the issue was very helpful. He noted that the Bank should try to find language that captured the spirit of the discussion and he would come back to Court on that. The Bank should also have more discussions with the Treasury about the change in the language.

In reply to a question from Mrs Heaton about the relationship to the funding of NewRO, the Governor said that the basic framework was acceptable but applying it was going to be difficult. The real issue was whether the CRD rate at the end of the day reflected the cost to the Bank or the additional cost of NewRO to the banks. In the short run, the cost of NewRO was going to be more than the reduction in the cost to the Bank. The guiding principle was that the overall cost to the Bank and NewRO should not increase. There was however bound to be tension between what the Bank spent and how much expenditure NewRO was confronted with. That was the next stage of the debate and it could not be advanced until it was seen what NewRO proposed. Mr Buxton commented that costs would be looked at as a whole, and no doubt the SIB costs would be more than those of the Bank. This was going to put pressure on the CRD rate. The Government had given an undertaking that costs would go down but that was not going to happen, he commented.

Mr Simms asked whether, with reference to discussions between the Court and the Treasury, there had been a change in the relationship between the two. The Governor said that he did not believe in this context that there had been a change. He noted that the Bill increased the independent role for Non-Executive Members of Court, who will have a nominated chairman. They would have an explicit responsibility. It would be exercised through the Annual Report, where they would have a section of their own. He did not exclude the possibility that the Chairman of the Non-Executive committee would have contact with Treasury Ministers, but that was not envisaged in the Bill. Mr Berkowitz noted that the letter referred to Court not a committee of the Court, so Court called the shots.

Sir David Cooksey commented that there was no provision for carrying forward a loss from one year to another. This meant that, if there were a loss in one year, it could not be used to reduce the dividend payment in the following year. The Governor said the Bank would look into that point. He noted that the sense of the discussion of the Bank's finances was that the basic framework was acceptable to Court and that there were particular points raised which would be clarified. He was very happy to write back to the Chancellor saying Court was content with the basic framework but there were a number of particular points made that the Bank would need to investigate and clarify with the Treasury officials, and also report back to Court. There would be two letters, one supporting the general principle and the other going back on the detail.

The Governor asked Mr Footman to take Court through a number of points on the drafting of the Bill. Mr Footman noted that the Bill was changing clause by clause as Court met, but he did not believe this was a matter of the policy changing but only of the words to express it. He drew attention to the role of Court in clause 2, which remained the same as in the version Court saw the previous month. Schedule 1 set out Court procedures and was substantially the same as the previous month. A change was that the Deputy Governors as well as the Governor, were able to convene meetings. Turning to the role of the Non-Executive Committee in clause 3, Court had been troubled by the characterisation of the matters delegated to the Committee as "management functions". The word "management" in the first lines of Section 3(1) and (2) of the draft Bill had been deleted. Otherwise the Section had been changed in only one respect: clause 3(2)(c) now had "securing" rather than "determining whether", which made it a bit stronger though in some respects it was the same. He noted that the Non-Executive Committee also had functions in clause 15, relating to the MPC. Mr Footman said that the designation of Directors remained because the Bank had failed to get this changed to Non-Executive Directors. There had been assurances from lawyers that the Bank could continue to designate Executive Directors as such, even though they were no longer Members of Court and this had been accepted by the Treasury. The Annual Report, in clause 4, was unchanged, and included the requirement for Directors to report as part of the Bank's Annual Report.

Turning to the MPC, Mr Footman said that this was constituted by clause 13 and its proceedings were governed by Schedule 2. These parts were unchanged, and followed closely the text of the Chancellor's first letter in May. He noted also that it was not EMU friendly, but this was never intended. He noted that a change had been made in line with a point made by Mr Allsopp at the last Court meeting, which was to the oversight role of the Directors. The Court's view had been that the clause should read "collected the regional, sectoral and other information necessary", to avoid any suggestion that regional and sectoral information was the limit of Court's responsibility. This was now agreed and in the Bill.

Turning to Court's role in the removal of members of the MPC, Mr Footman said that the Treasury had been persuaded to think again about Court, rather than the MPC, having the formal involvement on the Bank's side in the disqualification of an MPC member. This was accepted as consistent with the review role given to the Non-Executives. On the preparation of the Inflation Report, the Bank had objected to the clause requiring the Report to be prepared by the MPC. The Treasury understood the difficulty. Clause 17 now had the Bank preparing the Report but the MPC had to approve its publication. Court had also raised the question of the power to direct bankers: the Treasury had decided to retain clause 4(3) of the old Act. The Bank had, in the past, had other powers, for example calling for special deposits. It had been proposed to the Treasury that the Bill should make clear that the Bank still had that power. The Treasury had gone to Ministers with a specific proposal but, at the end of the day, the Chief Secretary had decided that it was better to leave the existing Act as it was: the Bank may, after consultation with the Treasury, issue directions to bankers, who have to be defined by the Treasury. The advice was that this would be difficult to operate. The main advantage was that people would think that it must mean something and that, if the Bank told them to do something, perhaps they ought to do it. The power had however never been used. It should be regarded as a threatening clause. Therefore the issue was not dealt with in the Bill, and the old power stayed, as in clause 4(3).

Mr Footman said that Court was seeing, for the first time, the new powers to collect statistics from banks, building societies, other credit institutions, financial holding companies and issuers of debt securities. Previously the Bank's statistics operation relied, rather precariously, on the goodwill of the banks, the 1946 Act power to request information from bankers and possibly even its role as a supervisor. The Bank felt it right to take this opportunity to put its statistics on a more formal basis. The power to obtain information was restricted to the Bank's monetary policy functions. MFSD currently collected data for supervision as well as for monetary policy purposes. NewRO had indicated that it would like the Bank to continue this for the time being, though in due course it would probably develop its own data handling capacity. Clause 26 of the Bill permitted NewRO to appoint the Bank as its agent for the purpose.

Turning to the transfer of banking supervision, Mr Footman said that the clauses were largely uncontentious. He noted that, in clause 27, the Board of Banking Supervision survived, against the odds. There would, however, be no Bank representation. The Deputy Governor for Financial Stability remained on the Deposit Protection Board, in clause 28. TUPE was confirmed as the condition for the transfer of staff to NewRO. There was also a scheme for the transfer of property to the SIB/NewRO.

There remained the matter of the Bank's Charter, which had to change. The question was whether it should be by the Bill or by the Crown. There was, at an earlier stage, the possibility that the Bank might take a new Charter, giving it powers to make the necessary amendments. That was no longer necessary. If new provisions were to be inserted, there would be a new supplemental Charter granted by the Crown for acceptance by

Court early next year. Either way, there was nothing to do now. Mr Footman also noted that, subject to the Charter, Court could determine its own remuneration. He said that the first reading of the Bill was likely to be on 28 October, and the second was thought likely to be 11 November. The Committee stage would probably be about two weeks after that.

Commenting on litigation, Mr Berkowitz said that last time Court discussed the issue, the proposal was that litigation should stay with the Bank. Parliamentary Counsel took the view that that was not appropriate. That implied a transfer to the SIB, which would be dealt with by an indemnity from the Bank. However, the Bank did not like this solution and it had now been agreed that litigation would stay with the Bank and the Bank would retain the conduct of it.

Sir David Lees asked whether the Bank's Annual Report to end-February 1998 would, under the timetable, be of the old style or whether there was a possibility that some of the issues in the Bill needed to be in the Report in February. Mr Berkowitz said this was a very good question and the Bank would look into how the transitional provisions worked. Sir David Lees said that, if it was the case that changes would have to be made to the February 1998 Report, it would be necessary to start planning in the not too distant future.

Preliminary Strategy Review and proposed new organisational structure

The Governor reminded Members that the Bank had held its annual Senior Staff Conference the previous Monday. Changes at the Bank were momentous in one sense, but when the Bank had begun the process of looking at the implications for the core purposes it reached the conclusion that it did not imply all that much change. The three core purposes were still monetary stability, financial stability, and the effectiveness of the financial system. On monetary stability, influencing decisions on interest rates had become taking the decisions. On financial stability, the change was the removal of supervision but, subject to that, the core purpose was the same. On the effectiveness of the financial system, there was no reason to change either. The Governor said that there would be a new draft of the three core purposes to be considered by Court in November but, in essence, he did not believe substantial change was necessary, and the same was true of the responsibilities and philosophy of the Bank and of the values statement.

The common view of GOVCO, MANCO and senior staff was that, whatever might be felt about the removal of supervision, it did actually remove a problem. There had always been the difficulty that this large block within the Bank was different in nature from the policy work being done elsewhere. That led to a difference in the style of the people in that function, which also led to problems in moving people across the Bank, leading in turn to difficulties for the one-Bank philosophy. There was now a new opportunity to develop this philosophy and make it work. The Governor drew Court's attention to the diagram of the organisation structure of the Bank, looking forward. It reflected the fact that the Bank would have two Deputy Governors. It moved away from the current two-wing structure. Part of the reason for that was the perception that it inhibited the cross-Bank interaction. There was a recognition, too, that financial market operations were relevant to monetary stability and financial stability. The draft of the diagram put to Court sought to establish an appropriate structure that recognised the monetary and financial stability parts of the Bank, with financial market operations servicing both, but also tried to emphasise the new focus on cross-Bank interaction. Central Services also needed to interact with the front line functional areas. They would report to the Deputy Governor for Financial Stability in the future, as they did now.

Sir Chips Keswick asked where did the Bank's own treasury function sit, by which he said he meant the risk management of the Bank's money. The Governor noted that this was in the middle area, and Mr Plenderleith would describe this in more detail later.

Mr King commented that, first, he himself had a great deal to learn; second, it was necessary to find the maximum synergies and to avoid turf wars; and third, market analysis was of fundamental importance. He noted that there were three kinds of work, employing distinctive talents. One was the use of analytical techniques to analyse market data; another was market intelligence, through those who dealt in the markets; and a third was market structures and financial institutions in the UK and overseas, in the Financial Stability area. The Governor had asked him to chair a working party to promote the maximum harmonisation of these areas and to minimise turf wars.

It was also important to promote accountability and transparency. This had been under way for several years, but there would have to be further improvements to the Inflation Report, and thought would have to be given to the minutes of the MPC. There was a new area of work in holding the MPC accountable to the public, through the Treasury Select Committee, and directly to the public and to Court for the way it carried out its business.

He also noted that for his successor as Chief Economist, the overwhelming objective would be to make the MPC work. In some areas of work, previous practice had been to write and publish papers. With the MPC, it was no longer possible to say that the answer would be given in six months time, since it now affected operational matters. He also noted that individual MPC members involved in projects with the Bank would require resources. Mr King said there were also a number of policy issues to be settled by the MPC, such as the horizon over which the inflation rate should be brought back to target after a shock pulled it away. There was still a fair amount of discretion for the MPC in this matter.

Turning to statistics, Mr King said that part of the work was the collection of statistics for supervisory purposes for an external customer, the SIB, which might later decide to set up on its own. MSFD must demonstrate that it could do a good job in the interim and also be a potential long-run supplier. Finally, Monetary Analysis was responsible for advising on monetary union, and on whether we should be in or out, and what the consequences would be.

Mr Plenderleith said that the Financial Markets Operations area was very much the Bank's bank. It covered payments, the Government accounts, the execution of monetary policy decisions and input to policy where it provided the Bank's window on the markets to gather intelligence. It followed that Financial Market Operations would contribute to all three core purposes. In doing so, it would be an area where policy and operations came together. And interaction between policy and operations was the quintessential element of central banking. He hoped that, in working with Monetary Analysis and Financial

Stability, it would enhance a sense of one Bank working on an integrated basis. It also followed that, because many of the functions were relatively mechanical, it would be necessary to have some analytical capacity in order to contribute to policy work. A more focused statement of strategic priorities for the areas concerned would be developed in the light of Court discussions, and further discussion with Monetary Stability, Financial Stability, management and staff.

There were three on-going tasks: the transfer of debt management, and local restructuring: the bringing to fruition of the strips market, the last great reform in the Gilts market that the Bank was taking the lead on; and the reform of money market structures and operations since, although there had been major changes in the Spring which had progressed satisfactorily, further fine tuning might be necessary. This would also have to be kept under review in the light of monetary union, even without UK entry. Mr Plenderleith said that financial market operations had also embarked on a major upgrade of management information and control systems in recognition of the fact that most of the Bank's financial risk would be in that area.

Mr Plenderleith noted that a proposal would be put forward to take out of the operating divisions a middle office. It would report not to the head of the operating division but to an alternative line of management, in line with best practice in most financial institutions. Another major area of work would be the impact of monetary union, and a third would be to continue to reduce the risk and increase the efficiency of the UK payment and settlement systems.

Mr Clark said he would sketch the work that might be done in the Financial Stability area and the changes that might have to be made in the way it was organised. He noted that monetary stability itself was clearly important to delivering the financial stability goal. There were three prime areas of concern for financial stability. First was the infrastructure, which went wider than payment and settlement systems and included the general environment in which financial business took place; that included an interest in the general shape of the regulatory regime. Second, there was monitoring and analysis of what was going on in the markets and among institutions, in something near to a real time framework. This had been done in the past but it would be necessary to do it more often in the future. It was not just watching, but interpreting. The third element was that it was necessary to have a capacity for crisis management. This involved analysis and, crucially, operational capability. He noted that Financial Stability had explicit responsibilities in relationship to the efficiency of markets. This had been part of the Bank's core purpose but it was now recognised externally in terms of the Memorandum of Understanding. Mr Clark said that a stronger international flavour would be injected into the work. It was also necessary to put more effort into analysis and understanding of market developments from the point of view of financial stability, and not just their relevance to monetary developments, and synthesise the Bank's views of threats to financial stability. The MOU envisaged a mechanism for taking stock of these issues in the standing committee. The Financial Stability area could contribute well-argued analysis to that process. Financial Stability also needed to support the Deputy Governor on the SIB Board and it would also try to expose in public some of its analysis on financial stability issues. Finally, it was necessary to establish close relations with the SIB at all levels. There were good relations with the SROs and the SIB but it was necessary to make sure that these relationships were captured in a more formal but not bureaucratic way, so that they would remain when the individuals concerned were no longer there.

The Deputy Governor said he strongly supported the one-Bank theme, and the departure of supervision made that easier. The organogram, with two analytical areas and one central operating area, reflected the reality of the Bank. There was some refining to be done on the detail of the organogram, including consideration of whether the Printing Works continued to report to the Deputy Governor. It would be a smaller Bank but easier to manage, particularly when it moved into one physical location.

The Deputy Governor said that, without pre-empting the debate to take place at the November Court, there were five areas on which to concentrate. The first was bedding down the MPC; the second was completion of the transfer of supervision and building good relationships with NewRO, in which context he was delighted that three of the top four in NewRO had spent time at the Bank - and everybody was delighted at the very senior position to which Mr Foot had been appointed in the new operation. Third, was the preparations for the euro including the role of the bank in negotiations as part of the British team, educating the City to ensure that it was ready, and the critical role inside the Bank of ensuring that the Bank itself was ready: the Audit Committee had looked at this and wanted to come back to the issue in a month or two. Fourth, in the Personnel area, there were difficult issues to face including recruitment and training, where it was necessary to look very carefully at a single corporate induction programme and also to complete the Bank Officer Review. The Deputy Governor commented that he was quite surprised when he arrived at the Bank to find the distinction between officers and officials, and it would have to be considered whether this was still appropriate to the Bank. There would also have to be consideration of salary issues arising out of that. Fifth, there were real challenges for Mr Midgley. There was an opportunity to shrink into one building but doing it was quite problematical. There were challenges in the accounting system, and the Bank would have to look carefully at its control systems. It would have to be certain that it was following best market practice as it applied to central banks. The Deputy Governor also commented that there should be a focus on greater discussion with clients than the Bank had had in the past. Some operations could be taken away from the Bank and some could be given to it. The Bank needed to be very sensitive to the audiences it was serving, and to the clients with which it was dealing.

Sir David Lees said it was very important for the Bank to have meaningful management accounts, and that responsibility was taken in the line and not in the function. The Bank would be under increasing scrutiny and its management accounting had to be of a high order. It seemed to Sir David that the Bank had some way further to go in that area. Sir David Cooksey commented that it had been noted that Heads of Department would have fully-devolved budget responsibilities. He believed that that was only possible with proper up-to-date accruals management accounting systems and the changes Mr Midgley had made to the quarterly report were not acceptable in that regard.

Mr Allsopp asked how much international focus could be built into the way the MPC worked, now that the international part of the Bank had gone. Mr King replied that international affairs had been in one Division but now the Bank thought it was such an important issue that every part of the organisation should be infused with it. Each Monetary Analysis Division included people working on international issues. Sir Chips Keswick commented that, against a background of cost-cutting and down-sizing, it was very important for the Bank not to lose sight of the investment likely to be needed in information technology. In reply to a question from Sir David Scholey, the Governor said that GOVCO and MANCO would both continue and there should also be further joint meetings. The distinction between the two Committees would, however, remain.

In reply to a question from Dame Sheila Masters about the purpose of the one-to-one relationship between Executive Directors and Deputy Directors in the Bank organogram, the Governor said that this was more apparent than real.

In fact, the Bank had three layers of management. There were the Governors, where the Governor and Deputy Governors were really not doing the same job. It was not one to one, since they had separate responsibilities. In the case of the Directors, the Deputy Directors had responsibilities distinct from the Executive Directors. The Bank would want to reflect this as two tiers of management, not four, when it developed the organogram. There were also the Heads of Divisions. So the Bank had three layers of management, not five. Sir David Scholey commented that he would like to see which activities were the responsibilities of Directors and which were those of Deputy Directors. The Governor commented that the organogram was meant to emphasise the relationship between large unit and different sub-units in the Bank.

The Governor commented that it was clear from the earlier discussion that the Bank was moving forward in an environment of very tight budget constraints. The loss of front line supervision meant that the Bank had to reduce overheads, not directly proportionately, but broadly proportionately, not necessarily by the same amount in each overhead area. That reinforced the need for lateral functioning within the Bank. Given the new areas of work the Bank needed to develop, it was even more important that there was no duplication and overlap. The Governor also noted Sir David Cooksey's comments on the quarterly financial report. He said that he was very anxious that there should be a reasonable discussion on monitoring and he suggested that it be deferred to November and invited Sir David Cooksey to talk to Mr Midgley again. Mr Midgley said he would like to talk to both Sir David and to Dame Sheila Masters. He also noted that an idea had been put forward in the Audit Committee that a paper should be put in by Mr Clark to outline best practice and to explain why, in some areas, the Bank was not following it.

Economic and Monetary discussion, including market charts (Professor Buiter in attendance)

Commenting on the minutes of the September Monetary Committee meeting, Mr King said a decision had been taken in August to pause for a time to assess directions from which risks were materialising. Noting the longer than expected period it had taken for the impact of the exchange rate on net exports to come through, Mr King asked Members of Court for their views on what was happening to exports. Possible explanations included longer lags than had been expected or an underlying improvement in trade performance. He also noted a rise in RPIX, mainly in goods rather than services, reflecting a strengthening in domestic margins. There was also a question about what was happening to domestic margins, he said. In the labour market the data were strong but there was no change in the rate of increase in earnings. He also referred to a note in folders on the construction sector, including the wage settlement. The headline rate was rather large. Even though construction earnings were more volatile than many other sectors, he believed that construction was one of the hot spots in the economy at present. He asked Court for its reaction to the content of the note on construction and comments on the construction industry.

Mr Plenderleith, turning to market developments, said that sterling had seen a precipitous fall, which was not unwelcome. For the past month it had been rather steady at 5-6% below the peak. This principally reflected developments in other currencies, particularly the deutschemark, because of a gathering sense that there might be a tightening of monetary policy, which was followed by the increase in interest rates last week with similar moves by France and other continental countries. There was also quite a substantial fall in UK gilt yields, principally on 26 September as a result of a notorious leak of the Government's attitude to monetary union. It appeared to have been driven principally by perceptions of what the Government attitude would be based on leaks and not supported by any announcement.

Sir David Lees asked whether there was anything on the import side which might give a clue to why exports may be stronger than some had thought. Mr King replied that import prices had not fallen as much as expected, given the extent of the appreciation of sterling. Perhaps importers were pricing to market, because of the strengths of the domestic economy. But the Bank had doubts about the accuracy of the import price data. He noted that the Bank's Agents had picked up a feeling that companies were prepared to take a hit on margins for the time being, but it would not be indefinite. The question was whether the fall in the exchange rate in August was sufficient to encourage them to go on for another quarter before cutting back.

Mr Neill said that the reaction of the components industry to short-term exchange rate movements was quite different. The car industry looked to complete systems solutions for models on a global basis. It was difficult if the exchange rate moved against you to abandon contracts because it put relations on a global basis at risk. He expected the effect of the exchange rate would be dampened and take place over a longer period. He recommended that the Bank look at the performance of the British supplier industry for new models of cars. He also commented that the scope for productivity gain in British industry was enormous and could compensate for the strengthening of the currency. He noted that nobody in the motor industry had expected the record performance in August and also that the industry had expected a correction in September, which had not emerged. October had also been expected to weaken but Government figures released that morning showed that sales were up 15% on a year ago, and private sales were also up 15%, which was exceptionally strong.

Mr Buxton said there was no doubt that total exports were more than expected but industry was still saying orders were down, so at some point volumes would drop. He also noted that consumer spending was still pretty strong. There would be inflationary pressure on the interest rate at some time. Sir Chips Keswick said that the fall in the exchange rate had greatly cheered exporters. Sir David Cooksey said that, in the technology sector business was as normal in the United States but a number of companies with which he was involved were withdrawing in Europe because they were building up to substantial losses, not just erosion of margins. The fall in sterling was still not enough to make that business worthwhile. Sir David Lees asked whether it was possible to distinguish in the figures between spot exports and scheduled exports, because the latter - which were under contract - could not so easily be withdrawn from. Mr King said that the answer was no.

Turning to the construction industry, Mr Simms said the industry's wage arrangements had been in an historic mess. That was why the three-year wage agreement attempted to trap wage inflation because it was expected that, in the end, the rise in costs would be less than it would have been if agreements had been reached piecemeal each year. He was sure that the recovery in the construction sector would continue, subject to there being no strong rise in interest rates. Investment in the industry was still very low. The return on assets was still below the cost of capital. In reply to a question by the Governor, Mr Simms said that workers in the industry were so low paid and the recession was so long that they were shaken out of the business, and it was not easy to bring skilled people back in. At the moment, the pressure in the construction industry labour market was in London and the South East and in particular trades and it was necessary to wait for the winter to see if this spread more widely. There was pressure in some other areas, but at the moment it was reasonably in balance.

Professor Buiter said he was fascinated by the replies given by Court Members to the question on exports. If productivity experienced a sharp upward shock, it may not necessarily be reversed, he commented. Sir David Scholey noted that the process of seeking anecdotal evidence of trends through the Agents had ratcheted up sharply. Mr King agreed and said the Agents were very clearly in place now as Agents to provide information to the Bank, and were more highly motivated and involved. Each month each Agent was given a question of the month, a well focused question, and went to see a dozen contacts within a week. At the end of a month that meant between 130 and 150 company responses. That was quite a respectable sample size. The MPC would chose a highly relevant topic each month. It was possible to send out the question and have the results back within a week. Each month, three of the twelve regional Agents attended the pre-MPC meeting and one of them presented the results of the work. Sir David Scholey hoped that as many Members of Court and the MPC as possible would go with the Agents on visits.

The Executive Report

The Deputy Governor gave a brief update on the Bank's preparations for EMU and on appointments at NewRO and staffing aspects of the transfer. He reported on how the division of staff was proceeding between NewRO and the Bank. Last month officers were told where their jobs were going and given the option to transfer. There were a number hoping to go in the opposite direction, but not a large number. The exercise was largely finished and one or two cases only were left. It had been very well handled.

Mr Plenderleith noted that the GCOII would be inaugurated on 10 November, and he also reported on the outcome of the Court case in which a former employee had been found guilty of theft from the Issue Office.

The Governor said that there were a number of domestic appointments to the boards of Bank subsidiaries and changes in shareholdings which, in accordance with Matters Reserved to Court, required the consent of Court. These resulted from changes earlier in the year of Deputy Governor, Secretary of the Bank, Chief Registrar and a proposed board re-shuffle at NMB. He drew Members' attention to a recommendation in their folders that consequent upon the appointment of:

(i) MR D C CLEMENTI to the position of Deputy Governor, and

(ii) MR P D RODGERS to the position of the Secretary of the Bank, and

(iii) MR G P SPARKES to the position of Chief Registrar,

and pursuant to Section 375 of the Companies Act 1985, as amended and extended by the Companies Act 1989, and until otherwise resolved by the Court of Directors:-

1 (a) MR D C CLEMENTI shall become a Director of <u>Bank of England Nominees Ltd</u> in place of MR GORDON MIDGLEY. The Board will then consist of Mr Clementi (Chairman) and Mr Plenderleith.

(b) MR D C CLEMENTI, or failing him MR IAN PLENDERLEITH, be authorised to act as the representative of the Governor and Company of the Bank of England at any meeting of <u>Bank of England Nominees Ltd</u>.

(c) MR P D RODGERS shall take a 50% shareholding stake in <u>Bank of England Nominees Ltd</u> in place of MR J R E FOOTMAN.

2 (a) MR D C CLEMENTI, shall become a Director of BE Property Holdings Ltd in place of MR H J DAVIES. The Board will then consist of Mr Clementi (Chairman) and Mr Midgley.

(b) MR D C CLEMENTI, or failing him, MR GORDON MIDGLEY be authorised to act as the representative of the Governor and Company of the Bank of England at any meeting of BE Property Holdings Ltd.

3 (a) MR P D RODGERS shall become a Director of Houblon Nominees in place of MR J R E FOOTMAN. The Board will then consist of Mr King (Chairman), Mr Midgley and Mr Rodgers.

(b) MR M A KING, or failing him, MR GORDON MIDGLEY, or failing him, MR P D RODGERS be authorised to act as representative of the Governor and Company of the Bank of England at any meeting of Houblon Nominees.

4 (a) MR P D RODGERS shall become a Director of BE Museum Ltd in place of MR J R E FOOTMAN. The Board will then consist of Mr Rodgers (Chairman), Mr Keyworth and Mr Midgley.

(b) MR P D RODGERS, or failing him, MR J M KEYWORTH, or failing him, MR GORDON MIDGLEY be authorised to act as the representative of the Governor and Company of the Bank of England at any meeting of BE Museum Ltd,

5 MR G P SPARKES shall become a Director of The Securities Management Trust in place of MR P W F IRONMONGER. The Board will then consist of Mr Foot (Chairman), Mr Midgley, Mr Kentfield and Mr Sparkes.

It was further recommended to Court that, pursuant to Section 375 of the Companies Act 1985, as amended and extended by the Companies Act 1989, and until otherwise resolved by the Court of Directors:-

6 MR NOEL MANNS of Richard Ellis, should become a Non-Executive Director of National Mortgage Bank in place of SIR IDRIS PEARCE. The Board will then consist of Mr Davison (Chairman), Mr Andrews, Mr Manns, Mr Kentfield and Mr Allen.

Court APPROVED the recommendations.

There were also a few associated changes, the Governor noted, which did not require Court's approval but resulted from the change of Secretary of the Bank. These were listed in Court's papers for information only.

19.11.97

A MEETING OF DIRECTORS AT THE BANK

WEDNESDAY 22 OCTOBER 1997

Present

Mr Clementi, Deputy Governor

Mr Clark

Mr Foot

Mr King

Mr Plenderleith

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 briefly about the state of the equity markets.

19.11.97

A MEETING OF DIRECTORS AT THE BANK

WEDNESDAY 29 OCTOBER 1997

Present

Mr George, Governor

Mr Clementi, Deputy Governor

Mr Clark

Mr Foot

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 Meeting, having been circulated, were noted.

The Governor spoke briefly about the state of the domestic markets.

19.11.97

A MEETING OF DIRECTORS AT THE BANK

WEDNESDAY 5 NOVEMBER 1997

Present

Mr George, Governor

Mr Clementi, Deputy Governor

Mr King

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 Meeting, having been circulated, were noted.

The Governor spoke about the foreign exchanges, including the Official Reserves figures for October and the state of the domestic markets.

19.11.97

A MEETING OF DIRECTORS AT THE BANK

WEDNESDAY 12 NOVEMBER 1997

Present

Mr George, Governor

Mr Clementi, Deputy Governor

Mr Clark

Mr Foot

Mr Plenderleith

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 Meeting, having been circulated, were noted.

19.11.97

A COURT OF DIRECTORS AT THE BANK

WEDNESDAY 19 NOVEMBER 1997

Present:

Mr George, Governor

Mr Clementi, Deputy Governor

Mr Allsopp

Mr Buxton

Mr Clark

Sir David Cooksey

Mr Foot

Mrs Heaton

Sir David Lees

Dame Sheila Masters

Mr Neill

Mr Plenderleith

Sir David Scholey

Mr Simms

Sir Colin Southgate

The Minutes of the Court of 15 October and the Meetings of 22 and 29 October and 5 and 12 November, having been circulated, were approved.

The Bank of England Bill (Messrs Footman and Midgley in attendance)

With reference to a Minute of 15 October, the Governor asked Mr Footman to describe progress on the Bank of England Bill. Mr Footman reported that it was introduced on 28 October very much in the form last seen by Court. A Memorandum of Understanding between the Financial Services Authority, the

Bank and the Treasury was published on the same day. Mr Footman noted that the Treasury Select Committee had published its own Report on 29 October, and the recommendations had been sent to Members. The main theme of the Report was accountability. Mr Footman also described evidence from Alastair Darling, Chief Secretary to the Treasury, given to the Select Committee on 5 November. That meeting discussed whether the Select Committee should hold confirmation hearings on the appointment of members of the MPC. Mr Footman noted that the Chief Secretary said he had an open mind, but had also made clear that what he meant was that his mind was open on the general principle of confirmation hearings across government, and that he did not want the MPC to become a special case in isolation from a wider decision on the policy.

Mr Footman also reported on the second reading of the Bill on 11 November, at which the Opposition attacked the Bill as giving too much power to the Bank. He noted some confusion in the debate between powers to set the inflation target and to set interest rates to achieve that target. There was also discussion about the fact that subject to meeting the inflation target the Bank had also to meet other government requirements on economic policy. He noted that the more MPs understood what that meant the less they liked it. Several Labour members abstained or joined the Conservatives in the vote.

The Committee stage of the Bill, which began on 18 November, was on a very fast track. The first session got through Clause 1 and Schedule 1, covering the appointment of Court. Noting that the Committee would turn soon to Clause 6, covering Cash Ratio Deposits, Mr Footman said that ahead of that the Government wanted to publish a consultative document on CRDs. He said the document was about the structure rather than the level of CRDs. It would be regarded as a rather minimalist consultation by those who pay CRDs. Mr Footman agreed with Sir David Scholey that the document would be used, by those who paid the CRDs, to express their views on the maximum appropriate level. He said that the only conclusion that could be drawn from the paper was that the amount raised would be the Bank's costs less £50mn, the cost of supervision that would be transferred to the FSA. If CRDs were constituted in the same way, that would lead to a 0.1% reduction in the level to 0.25%. In response to a question from Sir David Scholey, the Governor agreed that in fact the Treasury would be aiming to lessen that with a further reduction from 0.25%. The Governor said he had heard a figure as low as 0.18% for CRDs. The only protection was that the Government would suffer first, since it reduced the return to the public sector.

The Governor also noted that in the Committee meeting the Economic Secretary to the Treasury had confirmed that it was the intention, notwithstanding a report in that day's Guardian, to reappoint to Court those Members whose terms have not expired by the end of February, for the balance of their terms.

Turning to the question of the reporting of the Bank's spending plans in the Annual Report, the Governor asked Mr Midgley to introduce a paper. Mr Midgley said his conclusions were that there should be increased disclosure in the Directors' Report section of the Annual Report. There should be no expansion of the financial statements, where the Bank would continue to follow the principles of note 1 to its accounts.

In dealing with costs in the medium-term, for year one, he proposed using a forecast of costs based on the Bank's budget and thereafter to adopt a planning assumption rather than use outline year budgets. This would probably be shown in chart form. He also proposed disclosing the rate of return, used as a planning assumption, not as a forecast. Furthermore he suggested illustrating ex-post the declining burden of CRDs, but with no forecast or detailed planning assumption, just a statement of intent that there would be no rise in the burden. Finally, in order to support the objectives, and the level of CRDs, the Bank would disclose operating costs by functions.

The Governor commented that the key question was whether the Bank published the operating costs on an ex-ante or ex-post basis. He invited Court to comment. Dame Sheila Masters expressed concerns about ex-ante budgets because it invited inappropriate discussions. No private sector organisations did it. Mr Simms and Mr Neill agreed. The Governor expressed surprise but noted the reaction and said he would report it to the Chancellor. He suggested that there may be a fundamental difference between the public and private sector. For the public sector it was normal to publish and determine a budget in advance. Dame Sheila commented that that was for a government department not for a public corporation. Mr Foot noted that it applied to Self Regulatory Organisations and the Securities and Investments Board, which published a budget in advance. Sir David Scholey commented that the Bank would be seriously handicapped in setting out the information and having it debated in public. It would lead to constant downward pressure on investment programmes. If forecasts were made in the Bank and justified ex-post there would be more operational flexibility to make the investment that was going to be necessary. The Governor commented that, if Court had approved a budget a year before, he would have difficulty in answering a question from the Treasury Select Committee about why the Committee could not be told about it in advance. It would mean saying he would not tell the Committee until the money had been spent. The pressure to reduce spending would be there whenever an investment was made, and the question was at what point in time should it be debated. He believed the pressure might be greater if the public and Parliament thought the Bank was not disclosing. Mr Buxton said he thought that the Bank would be made to present and probably to publish information. The discussion should be about the way the Bank presented the ex-ante figures, rather than simply saying the Bank was in the private sector and that it should not publish. Mr Allsopp said he agreed because policy was moving in the direction of accountability. Keeping cards hidden was not realistic in the current political climate.

The Deputy Governor agreed that the pressure was to keep costs down. The Bank was willing, as Mr Midgley had indicated, to set out medium-term cost indications, but it was concerned about setting out detailed ex-ante costs for each department. People would spend 12 months slavishly following the published budget, and it would reduce flexibility. He suggested that the overall cost should be published ex-ante, but the detailed costs should only be published for each department ex-post. Mr Buxton agreed. Sir David Lees commented that the Bank should move gradually towards ex-ante reporting by function but not do it this year. He said the Bank was essentially a cost based organisation because the income side was more or less fixed. Mr Buxton suggested that it was possible to cover quite a lot of detail in the commentary of the Annual Report, rather than giving each department budget.

The Governor asked Court whether the objection to publication of the detail would apply as much if it was on a functional basis rather than a departmental basis. A functional basis was the suggestion in Mr Midgley's paper. Sir David Cooksey, noting that most of the people round the table were from the private sector, said that there could be a tendency to set loose budgets to keep flexibility. This was not a culture that those in the private sector wished to see. He also noted that whenever tensions arose there might be a witch hunt, during which questions were asked about why the Bank had done a particular thing. Details should not be published to the extent that it led to a witch hunt. He also commented that Bank salaries had to be affected by City salaries, and that the Bank could not live within a Civil Service framework.

The Governor said that he believed that part of transparency was giving information up front, and if what was said was not liked then there would be an argument. Mr Neill recommended that the Bank presented as little information at a detailed level as it possibly could. It was for Court to bring its experience to bear to ensure that the Bank was run as efficiently as possible. If Court did not do this, it would be done by the Government or by some Parliamentary committee. Mr Simms agreed with Mr Buxton that the Bank had no option but to put macro information into the Report and also to put quite a lot of detail in. The Governor said that the Bank would draw up proposals and show them to Court. The proposals would mock up as fully as possible the disclosure the Bank would be committed to on the basis of the discussion in Court. He said he was grateful for this discussion which had helped clarify his mind. The Bank would hold off writing to the Chancellor until Court had had a chance to comment on a concrete proposal. It was accepted that there was a need to publish some ex-ante information, but there were reasons why the Bank would not want to publish absolutely everything, and it would need to explain this to the Chancellor and the public.

The Quarterly Financial Report (Mr Midgley in attendance)

In introducing the Quarterly Financial Report, which had been deferred from Court the previous month, Mr Midgley said income had begun to pick up because of higher interest rates, while expenditure, because of vacancies, was less than had been expected at the beginning of the year. These trends had been evident in previous quarterly reports. An issue, as the Bank started to move towards the end of the financial year, was whether it should provide extra additional expenditure that it knew it was going to face as a consequence of restructuring. This was for the Audit Committee in December. He noted that he had discussed with Dame Sheila Masters and with Sir David Cooksey how the Bank's budgets should be constructed.

The Governor asked Court for comments on the form of the quarterly report, and what it might contain. Sir David Cooksey said that the quarterly report was moving somewhat in the right direction. But he saw a problem in the way staff of the Bank received the information as an estimated outturn for the year, with no accruals. Dame Sheila Masters said that the form of the presentation did not match best commercial practice. The Governor said he had lived with the Bank's system of control and the only comfort he got was that over a long period it gave an outturn consistent with budget. He said he could see that Members of Court would like the figures on a quarterly basis. Sir David Cooksey said that the Bank was moving to new responsibilities for the Non-Executive Directors. There was a balance to be struck between what the Non-Executive Directors were responsible for and what they would like to have to be sure of discharging their responsibilities. It was quite difficult to do that with the figures presented by the Bank.

The Governor agreed. He said that it would be sensible to break down the figures by quarter before starting any move to monthly figures. Sir David Lees commented that quarterly figures would be enough. Sir David Scholey said that another question was the response of managers to the figures. The figures could be interpreted as showing the Bank was ahead of budget on revenue and below it on costs, which might seem to suggest that everything was all right. That might not be the correct response to generate from management. The Governor said he took from the discussion that it would be helpful to put the annual budget on a quarterly basis. Sir Colin Southgate suggested that the Bank could agree key criteria with major departments, and job numbers might be one of them. It was necessary to get the measurements agreed with the manager, and with the Deputy Director or Executive Director, and then report variances from the reported figures every quarter, and an explanation of why such variances had occurred. The Governor said Mr Midgley would be asked to produce quarterly accounts on a simplified basis. In response to a question from Mr Simms about whether Court could also have historic data, the Governor agreed.

Turning to the figures in the quarterly report, the Governor asked for comments. Mr Buxton said quite a lot of the savings were staff vacancies which the Bank wanted to fill. He related that to salary levels in the Bank. Was the Bank finding it difficult to fill those places because its salaries were not competitive and would that affect the performance of the Bank? Court ought to debate the issue. The Governor agreed. In response to a question from Sir David Scholey he also commented that the problem was not a shortage of applicants but a shortage of people of the calibre the Bank wanted to recruit. That was certainly true of Supervision & Surveillance. Turning to the timing of the introduction of the new quarterly reports, the Deputy Governor proposed that the reports be left as they were for the current year and that the Bank should move on to the new basis in 1998/99. That was partly because the accounts needed to reflect the new management responsibilities.

The Bank's Strategy (Mr Midgley, Ms Lowther and Mr Allen in attendance)

With reference to a Minute of 15 October, the Governor asked the Deputy Governor to introduce his strategy paper. The Deputy Governor noted that there had been two half day sessions jointly between GovCo and ManCo and a one day meeting at Sunningdale with Heads of Department. The paper covered what the Bank intended to do and how it would carry it out. It was determined in part by the decisions in May and by the Memorandum of Understanding. He noted the importance of the role in financial stability, and also the continuation of central banking functions without debt management but with some foreign exchange reserves management. He drew Court's attention to an organogram in an annex to the paper and noted that, with supervision moving out of the Bank, it was intended to ensure that the barriers across the Divisions were low. He noted that some Heads of Division had argued that the new structure was top heavy relative to the private sector, and that was probably so. But he believed that Court would recognise the amount of public policy work and representation that the Bank carried out and direct comparison with the private sector was difficult. He also drew attention to the table on page 12 detailing possible changes in headcount at the Bank and said that he had asked for an examination of the resources that would be needed. Property Services, Personnel and the rest of Central Services were close to 40% of the total and it had to be recognised that, after the loss of Supervision & Surveillance, the Bank had to bring that back into some sort of balance. In response to a question from Mr Neill about whether the Bank had a view on compulsory redundancies, the Deputy Governor said it had historically had a view, but that was one that would have to be reconsidered, though he noted that with the closure of the Branches the Bank had in this case adopted compulsory redundancy. Such measures might need to be considered for Property Services but in some other areas of the Bank reductions might occur naturally. It might be necessary to come back to Court with the issue. If the Bank went for compulsory redundancies it would achieve its objectives quicker.

Mr Buxton commented that there should be more emphasis on risk management. He also believed that the Bank's strategy with the Printing Works and Registrar's should be to make them competitive in the outside world. The Bank was doing that with the Printing Works but in a half-hearted way. He took the same view of Banking Services, and said he could not see why the Bank had private current accounts. The Governor said it was always difficult to know whether the Bank should compete to test efficiency or whether it was appropriate to compete as a public sector organisation with institutions that it supervised or with the private sector, where the Bank may have advantages. But the Bank could have that debate again.

In reply to a question from Mr Buxton about why the Financial Services Authority could not take some of the Bank's overhead staff to reduce its costs, the Governor said that the SIB and other organisations already had their own overhead staff.

Sir David Scholey commented that the strategy paper was excellent. He noted three points: he believed there was not enough emphasis on training and management development on a continuing basis; in the revision of the core purposes there was only a passing reference to supporting the Government's economic policy, including growth and employment, and he believed that should have a higher profile now that it was in the Bill; and he recommended that Executive Directors should be permitted to attend meetings of the new Court after the Bill had been enacted.

Sir Colin Southgate asked whether in the organogram a Deputy Director sat over all the parts of an Area or whether he also ran one of the Divisions. Was there a one to one relationship to the Executive Director? The Deputy Governor said he did not believe it worked that way. The Executive Director was on GovCo, which was responsible for strategic direction, and Deputy Directors were on ManCo and worried about management and personnel functions. The Bank expected Executive Directors and Deputy Directors to speak with one voice but concentrate on slightly different things managerially. Sir Colin commented that this appeared to be a top heavy structure. The Governor replied that in some respects it was more like two people side by side, as compared to a one to one relationship. Sir Colin advised the Bank to look again at the organogram before it was published.

Mr Simms remarked that this was a communications issue because the Bank had five layers down to Heads of Division. The Bank should be aware of this and should make sure that communications issues were addressed in order to make it work. Turning to Bank policy on redundancy, Mr Simms said that if it was necessary to cut the numbers substantially it should be done immediately. It would be wrong to leave an overhang that would affect morale, and those that the Bank did not want to leave would then vote with their feet. The Governor said that the issue would be addressed when the Bank knew what was likely to be needed.

Sir Colin Southgate commented that the Bank had the opportunity of a lifetime to do a zero based budget, and he believed that the result of that would be lower staff numbers. Sir David Lees noted that the strategy document referred to working very closely with the Financial Services Authority and he recommended that the document should note how the Bank could most effectively share data with the FSA. Referring to the annex to the strategy document, the pocket version of the Bank's Purposes, Responsibilities and Philosophy, Sir David questioned whether the sentence "to consult and persuade, not to dictate," was correct, given the changed responsibility for monetary policy, where the Bank very clearly dictated the trend. The Governor replied that this was an interesting point, but the sentence was related more to relations with the market place. Sir David Scholey suggested that the subsequent sentence, that the Bank's philosophy was "to favour market solutions, but consider intervention when those are not possible," should be combined with the sentence "to consult and persuade, not to dictate," in order to make this clear. The Governor agreed.

Mr Allsopp said that the first core purpose was not sound money but the control of inflation. The Governor said that the full version of the Purposes, Responsibilities and Philosophy, the next annex, drew attention to the primacy of price stability in maintaining the integrity and value of the currency. Sir David Lees said the longer version worked well and the problem was really the translation to the pocket version. Turning to the strategy document itself, Mr Allsopp said it embodied a belief in the long run neutrality of money, and he was not sure that that should be put in. It would not be agreed by everybody all the time. The Governor said the Bank would look at that. The Governor thanked Court for its contributions and said they would be fed into the budget process, and would come back as part of the Annual Report.

[Mr Midgley, Ms Lowther and Mr Allen withdrew.]

In response to a question from Mr Buxton about the professional qualifications of Personnel Directors, [redacted] Mr Neill said that Ms Lowther had spent time with his company. In his view, he would not have professional Personnel Directors and Human Resource Directors in charge of change. He would find a good line manager. He agreed with the Governor's comment. In response to a related question from Sir David Lees about the position of Finance Director, the Governor agreed that there was merit in exposure to the practices of the private sector.

The Executive Report

The Governor said the Bank proposed to appoint John Vickers, Drummond Professor of Political Economy at Oxford University and Fellow of All Soul's College to succeed Mr King.
Mr Vickers was not a macro-economist but had an extraordinarily strong reputation, nationally and internationally. The Bank

believed it would be a positive advantage to have someone who would bring a very acute economically-trained mind to bear on macro-economic issues. He commended the appointment to Court and said that if Court agreed it would be announced that afternoon. The name had been communicated to the Chancellor who was content. The press notice would also announce the appointment of Richard Brealey, Tokai Bank Professor of Finance at the London Business School, as an Adviser to the Governors on financial stability issues. He would join the Bank in early spring. Court APPROVED these appointments.

The Governor advised Court that he was leaving to attend a lunch for The Queen and the Duke of Edinburgh in honour of their Golden Wedding, and he asked the Deputy Governor to chair the remainder of the meeting.

The Deputy Governor said that following the departure of Howard Davies last summer, Court was asked to approve his own appointment as a trustee of the Houblon-Norman Fund in place of Mr Davies. He drew attention to a resolution in Member's Court folders. It was RESOLVED that, in pursuance of Clause 3 of the Trust Deed of the Houblon-Norman Fund, Mr D C Clementi, in his capacity as Deputy Governor, be appointed to succeed Mr H J Davies as a trustee of the Fund with immediate effect.

Mr Plenderleith drew Court's attention to a written paper in the Executive Report which commented on the inauguration of the new CGO system on 10 November.

The Deputy Governor drew attention to correspondence with Peter Lilley MP, the Shadow Chancellor, who had written to the Bank last month inviting it to initiate an investigation into market price movements since 26 September, following a number of press reports on the timing of the UK's entry into monetary union. The Bank's reply was included in the papers. There were no comments.

Two Recommendations from the Remuneration Committee

Sir David Scholey, in his capacity as Chairman of the Remuneration Committee, presented to Court the following recommendations:-

Following their appointment to the position of Adviser to the Governors -

(a) Sir Alan Budd's remuneration be [redacted] representing 4/5 of [redacted] in respect of a four day working week, he having joined the Bank with effect from 16 November 1997;

(b) Professor Richard Brealey's remuneration be [redacted] representing 4/5 of [redacted] in respect of a four day working week, with effect from a date, yet to be announced, next spring.

Neither post carried a pension contribution.

Court APPROVED the recommendations.

A Report of the Audit Committee

The Deputy Governor invited Sir David Lees, in his capacity as Chairman of the Audit Committee, to comment on a report of the Committee. Sir David drew Members' attention to a number of points in the minutes, and said a critical issue was that the risk matrix should properly reflect the risk the Bank was exposed to. He particularly drew Members' attention to a discussion at the Audit Committee on the concentration and lack of choice in accountancy and auditing services which would occur if the proposed Coopers & Lybrand and Price Waterhouse merger proceeded. The Committee concluded that it would not be appropriate to recommend that the Bank should formally raise objections on these grounds. The regulators might wish to do so, of course, for operational reasons. Sir David said that since then a second merger had been announced and this did raise a wider issue for the Bank. He referred to an intention to put out to tender the Bank's audit. This had been postponed because the Bank could not find enough firms without a conflict of interest. If both mergers went through there would be two fewer auditing firms, and that was an issue for the Bank. It might also be an issue in relation to matters other than Audit.

Turning to the risk issue, the Deputy Governor said with the agreement of the Audit Committee he had asked for a report from Coopers commenting on whether controls followed best practice in the private sector in so far as they related to a central bank. Turning to the auditing point, the Deputy Governor remarked on the concern that a number of people in the Bank felt at the possible reduction in number from six to four firms. Mr Foot found it the most difficult. It was often hard to find a firm that was not conflicted out. It was a reduction in choice in an industry with very high barriers to entry. He and Mr Clark were discussing whether the Bank should submit a paper to the competition authorities in the UK, and he was happy to hear Court's views either immediately or later.
Mr Clark said it was thought that a paper might be submitted in the next two to three weeks, and it would probably go also to DGIV in Brussels.

On the question of risk, Mr Buxton asked whether the Bank had a compliance officer. The Deputy Governor said that on arrival he had discovered that it was probably himself.
Mr Plenderleith commented that he did not believe that a

compliance officer separate from the management and control functions of the new Middle Office was necessary. But if colleagues felt there was a need for a separate compliance function he would be glad to hear what they had in mind. The Deputy Governor said the issue would be considered. In the private sector there was a control function and a compliance officer sitting alongside. In a sense, the Auditor was the closest to that function in the Bank. The issue would be brought to the Audit Committee and to Court as a whole. Mr Buxton commented that someone should be seen as a senior person in the organisation carrying the compliance responsibility, and it could be the Deputy Governor.

Turning to the auditing point, Sir David Cooksey commented that the mergers would eliminate choice, cause prices to rise and on occasion would prevent deals being done. Sir David Scholey noted that, when similar consolidation had occurred among leaders of the legal profession, two or three other firms were reinvigorated and began to compete with them. Dame Sheila Masters said that the barriers in accountancy to entry were quite high, while smaller firms did not provide a full service. She was referring not to advisory work but to high quality assurance, she said.

Economic and Monetary Discussion and the Inflation Report - including a paper addressing Large v Small and Medium Capitalisation Stocks: a comparison of Equity Markets in 1987 and 1997. (Messrs Allen and Hayes together with Dr Julius and Professor Buiter in attendance)

The Deputy Governor asked Mr Allen, in Mr King's absence, to present the Inflation Report. Mr Allen said that the August Inflation Report showed strong domestic demand, speculated about a sharp weakening in net exports, showed the central projection for inflation on target and indicated that the risks were predominantly on the upside. The November Inflation Report contained more evidence to assess the way risks had developed in the meantime. On the upside there was no sign of a clear deceleration in broad money, but the windfalls surveyed by MORI had reduced the scale of the upside risk seen. On the downside, there was not much sign of a deterioration in net exports, even three months later, as a result of the exchange rate. There were signs of further tightening in the labour market but no acceleration in earnings. Mr Allen drew attention to the appearance for the first time in the Inflation Report of a projection of output growth. It was expected that growth would return to trend during 1999 after dipping in 1998. He emphasised the uncertainties in the projection. He also drew attention to the inflation projection, which indicated a dip next year which was less than in August, reflecting the experience of the last few months. Mr Allen noted the 1/4% rise in interest rates announced by the Monetary Policy Committee in November in order to meet the inflation target. It had considered whether developments in the equity market made a case for leaving rates unchanged, but it did not regard them as an inhibition.

Commenting on the markets, Mr Plenderleith said it was a tale of two worlds. There was a considerable disturbance in Asian markets, spreading in recent weeks to Japan. That carried risks to the macro-economy and the stability of the world financial system. The main markets were not particularly affected by this, other than the yen. Sterling had been tending to edge upwards, partly because of relatively strong data and partly because of clarification that sterling was not to be in monetary union at the start. Sterling market interest rates rose 25 basis points when the MPC raised rates but the forward curve was still downward from mid-1998 and into 1999. The market expected possibly higher rates in the short run but saw some possibilities of a fall afterwards. Equity markets had been disturbed. However the FTSE100 index was only back to the level of spring.

Mr Allen said that Sir David Cooksey had suggested that the Bank did not adequately look at the difference in behaviour between large and small stocks when examining the behaviour of equities. The paper before Court had been produced as a result. Mr Hayes said that since January the all share index had risen 15%, the FTSE100 by 20% and the small capitalisation and mid-market stocks by 4%. It might be a characteristic of bull markets, but looking at 1987 the FTSE100 would have risen 37% and the FTSE250 by 52%, in other words it had outperformed the FTSE100. The paper made a number of suggestions as to why smaller firms may have de-coupled in performance from the larger ones. The reasons included exchange rates and the question of foreign investment in UK equities.

The Deputy Governor asked for Court's views in the light of the fact that the MPC had been more criticised in November than in any of its previous decisions. Mr Neill drew Court's attention to benchmarking studies by the CBI which showed the great potential benefits if British firms increased their productivity to the average of the best of their competitors. If the Bank wanted to counter the arguments of industrialists who said that the strong pound was damaging Britain's ability to compete, it could say improve your productivity. Reporting on the construction industry, Mr Simms said that the business was mostly in the UK so sterling did not have much effect. Construction was still robust, though it had been soggy in the third quarter as a result of the election. The industry was not too worried about interest rate rises so far. In the labour market it was clear that wage rates were rising quite strongly, and were back to 1990 peaks in London and the South East. For the first time he was beginning to hear of pressure on the labour markets out of London. He also noted that changes in labour market rules made in the spring might push up labour costs, but by how far he did not know. Having lost 500,000 people in the previous six years, new people were now coming into the industry, which had gained 34,000 employees in the year so far. This was part of the reason for the emergence of labour market pressures.

Sir David Cooksey said he was grateful for the paper on large and small capitalisation companies. He asked a further question, about what had happened to relative liquidity. Smaller companies had lost liquidity. Sir David commented that with a number of companies with which he was involved, because access to the equity market had been shut down, some companies were beginning to stretch their covenants with banks.
Mr Buxton commented that the paper left out the point that financial institutions were quite a high proportion of the larger stocks. They were also a high proportion of the smaller index. The large rises in their share prices were a result of a re-rating against the index. Turning to the export situation, he believed the explanation of the resilience of exports was the long lead time in export market orders. At some point exports would still drop off. He also commented that the labour market was definitely tightening. The driver was expansion in the service industry. In response to a question from Sir David Cooksey about whether Barclays Bank was seeing more companies hitting covenant limits, Mr Buxton said this had been a factor, but it was not a major problem.
Sir Colin Southgate commented that music industry sales figures

were very flat, and there were inflows of imports to the UK. Two years ago it was the opposite. The market for his company was weak but he did not believe that it was anything to do with the UK economy and it had more to do with the music. He did not see shortages of staff except in niches, which everybody knew about, such as information technology. Sir David Lees commented that he did not see much change in the situation this month. But he expected to have a little more difficulty in the labour market.

Mr Allsopp commented that it was a very good Inflation Report. Where it came out very well was in the way it described uncertainties. He commented that it was rather short on the detail of the transmission mechanisms. He strongly welcomed the projections of output. He suspected that the MPC was under pressure to be more and more like an ordinary forecaster in having to be more explicit about how its models worked.

Professor Buiter said he was interested to hear about the labour market situation from Court, because it was one of the great unknowns in the MPC's forecasting. He got a sense that there was a tightening but not of when that would translate into significantly higher earnings growth. On the Inflation Report, he welcomed Mr Allsopp's comments and said it was important that as much information as possible was presented about the projections. How much more was a subject for continual discussion at the MPC.

Dr Julius said that where the Inflation Report was concerned it was very much in members' minds how to improve it, including the presentation. There were people wanting models and more equations. There was another broader clientele for whom that would obscure what the MPC was trying to do. It was a difficult judgement to call. What sort of report would communicate in the best way to the entire clientele? Turning to the exchange rate effect, and the question of whether that would be a stimulus to increased productivity, she said it was possible that the Committee was seeing signs of that in the response of exports to strong sterling. Even if that was the case, there would have been even stronger exports growth without the high pound. But the stimulus to productivity from sterling was not the Committee's basic assumption. Rather it was one of the factors it had continually to assess.

In response to a question from Sir David Lees, Professor Buiter commented that the MPC believed that the effect on net exports was delayed, but each month that exports did not drop it had to give greater weight to the possibility that there had been a lasting change. The Deputy Governor thanked Court for a useful exchange of views.

The Governors' Engagements

The Deputy Governor, after noting the Governors' engagements, asked whether there was any other business. Sir David Cooksey raised the question of Japanese banks. Mr Foot said that reactions to the stock market collapse at the end of October had been encouraging. Only one small bank had been in difficulty. The further decline in the Nikkei had accelerated concerns, particularly about Yamaichi, which had a bank and a securities company in London. There had been close consultations with the Japanese and US authorities to make sure that there was no problem. One or two counterparty problems had been fixed. A problem had occurred again that morning because Yamaichi shares had fallen very sharply overnight. He noted that most Japanese banks had uncomfortably low capital ratios. The decisions made about Hokkaido Takushoku had been good, but the Japanese had wasted that by contradicting what the Prime Minister had said about the willingness of the Government to support the banking system. The focus had moved on to Korean banks, which were to an important extent financed by Japanese banks. The Bank was working very closely with the SFA and with the Japanese authorities. The Koreans were not so forthcoming but had been to see the Bank. In summary, the Koreans and the Japanese had problems to address, and the Bank was there to help. Sir David Scholey noted that he had been in Japan the week before last, and had never before heard the non-banking community in Japan speaking so openly and critically about the performance of the country's banking system. Mr Buxton commented that it was a source of surprise to him that the Japanese were still being quite aggressive as lenders. They should have been cutting their balance sheets, but were not.

Court ended.

17.12.97

A MEETING OF DIRECTORS AT THE BANK

WEDNESDAY 26 NOVEMBER 1997

Present

Mr George, Governor

Mr Clementi, Deputy Governor

Mr Clark

Mr Foot

Mr King

Mr Plenderleith

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.

17.12.97

A MEETING OF DIRECTORS AT THE BANK

WEDNESDAY 3 DECEMBER 1997

Present

Mr George, Governor

Mr Clark

Mr Foot

Mr Plenderleith

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 Meeting, having been circulated, were noted.

Mr Plenderleith noted that the Official Reserves figures for November published the previous day included, for the first time, details of the change in the Bank's own holdings of foreign currency and gold during the previous quarter.

17.12.97

A MEETING OF DIRECTORS AT THE BANK

WEDNESDAY 10 DECEMBER 1997

Present

Mr George, Governor

Mr Clementi, Deputy Governor

Mr Clark

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 Meeting, having been circulated, were noted.

17.12.97

A COURT OF DIRECTORS AT THE BANK

WEDNESDAY 17 DECEMBER 1997

Present:

Mr George, Governor
Mr Clementi, Deputy Governor
Mr Allsopp
Mr Buxton
Mr Clark
Sir David Cooksey
Mr Foot
Mrs Heaton
Sir David Lees
Dame Sheila Masters
Mr Neill
Mr Plenderleith
Sir David Scholey
Mr Simms

The Governor welcomed Members of Court and invited them to join him afterwards for lunch with former Governors and Directors of the Bank, including Lord Roll and Sir Jasper Hollom who had recently celebrated their 90th and 80th birthdays respectively. He also welcomed Sir Alan Budd to his first meeting as a member of the Monetary Policy Committee.

The Minutes of the Court of 19 November and the Meetings of 26 November and 3 and 10 December, having been circulated, were approved.

Economic and monetary discussion including market charts (Mr Allen, Professor Buiter, Sir Alan Budd and Dr Julius in attendance)

Mr Allen discussed the provisional national income figures which the ONS had released on 20 November, after the Inflation Report was published.

The main differences between the estimated outturn and the Report's November projection were that GDP growth was thought to have been a little lower than the Bank projected, though the discrepancy was well within the range of likely revisions. Domestic demand was thought to have been quite a bit weaker than the Bank projected and net exports quite a bit stronger. The unexpected strength of exports in Q3 partly reflected short-term fluctuations in external trade in oil and erratic items rather than anything fundamental, but the Bank was still surprised that there was not yet a larger fall in net exports. Surveys of orders for manufactured exports took a sharp turn for the worse in the third quarter, though there were signs of a modest improvement in the fourth quarter. Agents' reports were telling much the same story.

Turning to national income, Mr Allen said there were big increases in both mining and quarrying, which includes oil and gas extraction, and electricity, gas and water supply. These categories of output were normally pretty volatile, and largely driven by factors such as technical production conditions in the North Sea, and the weather, which affects electricity and gas production. Leaving out these categories, GDP growth in Q3 was about 0.75%, compared with 0.9% on the comprehensive measure. All the figures were subject to revision.

There was not yet much hard data from the fourth quarter. Industrial production was down in October. Survey evidence did not suggest any dramatic change in the rate of growth of manufacturing. Retail sales were sharply up in October - probably a reaction to the Diana effect in September, and modestly down in November. The figures had been erratic. Comparing the latest three months with the three summer months before gave a small increase of 0.2%.

The latest trade figures showed a wider deficit in September, and there was a hint in the area breakdown of the October figures for trade with countries outside the EU that the problems in Asia may have had some effect.

The latest labour market figures showed unemployment continuing to fall, and employment continuing to rise, at much the same rate as in the preceding few months. Underlying average earnings growth remained at 4.25% in October - only 0.75% higher than in October 1996.

Producer output prices had continued to be very restrained and there were further falls in input prices in November. RPIX inflation remained at 2.8% in November.

Mr Plenderleith said there were three aspects to the markets over the past month. Most of the main action had centred on the Asian economies and there had been relatively little movement in the major Western European and North American markets. He noted that sterling was softer because of a wider perception in the market that the economy might be slowing. He described the falls in the currencies and stock markets of a number of Asian countries. Turning to the UK he said that the yield curve suggested expectations of a cut in interest rates in 1998 and into 1999, when rates would come down to about 6.5%. Mr Plenderleith also noted that the real yield on UK index-linked gilts had fallen sharply in the last month or two from about 3.5% to less than 3%, which represented both an absolute fall and an out-performance against the United States where real yields were still in the order of 3.5%. Mr Plenderleith commented that quite a large part was due to increase in demand by pension funds adjusting to new legal requirements. It was quite a sharp move and one which the Bank needed to monitor closely.

The Governor commented that the Bank was in one of those gloomy phases in which it was looking for, welcoming and expecting a slowdown. The issue was whether the slowdown would come soon enough to head off inflationary pressures. Commenting on the industrial situation, Mr Neill said that in the first ten days of December the car industry had surprised everybody with retail sales 27% higher than in the first ten days of December in 1996. This compared with a 14% increase in November as a whole. Nobody had forecast such an increase for December. Imports were also at a record of 66% of the market and this was viewed as a factor that would continue for the foreseeable future. He ascribed it partly to the exchange rate effect and partly to the introduction of new models by continental manufacturers. Turning to the construction industry, Mr Simms said sentiment was cooling and there was a scaling back of expectations. Forecasters were starting to lower their expectations for 1998 and the first half of 1999. While the industry would carry on growing because of orders in the pipeline, it would be more slowly. He had little doubt that interest rates did affect the outlook. The industry was anxious about the Asian situation and the impact on the construction sector in the UK. Asian investment was a not insignificant percentage of the industrial buildings market. Private commercial work - the biggest sector - was very strongly up, and would carry the overall market forward for a year or so. Some forecasters were saying that tender prices would rise but he did not believe that this took account of recent cooling. The West Midlands picture was not markedly different from the national average, though it was a little stronger. There were also indications that, nationally, total take home pay was rising and, as a result of PAYE changes in April 1998, there would be an increase in wage rates, though he expected this to be absorbed by companies.

Sir David Lees said that not much had changed, except pressures on prices at the sales end. With price increases very hard to come by, there were going to be huge pressures again on productivity. Mr Buxton commented that business confidence at the moment had fallen slightly, but not by much. There were signs of a slight slow down, with start-up finance down and business confidence at the branches also slightly down. Personal lending levels were still near forecast. Mr Buxton commented that he was not looking for lower interest rates. He did not believe there was a slowdown to the extent some of the figures were showing. Turning to export markets, he noted a conversation with a company that said exports had held up because they had been fully hedged during 1997. They expected export levels to be lower in 1998. Sir David Lees agreed that the hedging effect was definitely a factor, and the Governor noted that this point had been made by Agents for quite a long time. The Governor noted that, in the Inflation Report, the Bank had anticipated a very powerful impact of the exchange rate on the net trade balance. Sir David Cooksey noted that a surprisingly high proportion, 80%-90%, of the companies with which he was involved had hedged against their budgets for 1998 but they were nevertheless predicting that volumes would be down by about 40%, and were struggling to secure even that level. He believed the downturn would come quite suddenly.

Sir Alan Budd said that if the MPC got things right business would never feel as confident as it did in 1988 and 1989. The subdued level, almost a sense of disappointment, was precisely what the MPC was looking for. Mr Allsopp noted the huge risks from the international economy because of the situation in Asia, including Japan. He had a feeling of deja-vu, reminding him of past periods when people lost sight of the true impact of such events, because they had a habit of hitting harder than economists thought they would. He also worried about some of the financial interactions that might follow. The Governor agreed, and said the point was extremely well taken. There were three quite separate worries. One was that the Japanese or Korean situation would lead to a systemic financial problem, which was a low risk but would bring huge damage if it happened; the second was that even if that didn't occur there was now a phase in which the IMF, the OECD and other forecasters were progressively revising downwards their expectations of world growth; and thirdly there was a problem not just of slow growth, but of global imbalance. This could lead to tensions in discussions at forums such as the G7. Sir Alan Budd agreed with Mr Allsopp, noting that the usual way of measuring the effects of such events was to use multipliers, but they were not nearly enough. Financial and political reactions could and did build into something much worse.

In reply to a question from Sir David Scholey, the Governor noted that what was happening in the global economy would be a significant factor in the forecasts in the Inflation Report. Dr Julius noted that some Asian economies were not nearly as diversified as those in the West, and had over-investment in certain sectors. That could rebound disproportionately on the same sectors in the UK. She said she supported Mr Allsopp's comments and added that, at the three meetings since the Asian situation began to develop, the MPC had spent more time at each meeting on the international dimension. She noted unease that conventional methods of analysis would only capture the transmission mechanism with hindsight. Professor Buiter said there was a possibility of a larger than expected contraction in the real economy. The OECD was now forecasting a 1% reduction in growth against previous forecasts of 0.25% off. There was a risk that policy reactions to the crisis were likely to aggravate it through fiscal tightening. The US was likely to be more protectionist as well. In addition there was a general confidence effect. Professor Buiter said he was sceptical about the latest IMF figures showing world growth slowing but growth in the United States and Europe picking up. There was a possibility of the international situation looking considerably worse that even the most pessimistic current forecasts. Mr Allsopp expressed the hope that Professor Buiter was wrong, or the start of EMU would look extremely difficult. The Governor noted that the potential problem was beginning to figure in some official thinking on Europe.

The Quarterly Supervision Report:- (i) Transfer of responsibility to the Financial Services Authority (ii) Traded Markets - practical issues (iii) Problems in the Far East (Messrs Page, Bereza, Miles and Wright in attendance)

Mr Foot noted the appointment of Carol Sergeant as Director for Banking Supervision at the Financial Services Authority and Clive Briault as Director of Central Policy. He also noted that, on the assumption that the Bill was enacted on or about

1 April 1998, it would be most appropriate for the FSA to produce the Banking Act Report because all the staff involved would be at the FSA. With the advice of lawyers it had become clear that it was possible to produce one document covering both remits - that of the Bank and of the FSA. At a working level, the FSA would show the Bank the relevant sections. That should relieve Court of having to plough through the material in the next few months. In response to a question from Mrs Heaton about building societies, Mr Foot said, that like the insurance directorate of the DTI, the Building Societies Commission would as regulators be legally separate until further legislation. But the BSC would prefer to be integrated as far as possible ahead of the legislation, and to go to Canary Wharf with the FSA. Societies would eventually be regulated in Mrs Sergeant's area. In response to a question from Sir David Scholey, Mr Foot said he expected that the Lloyd's insurance market would eventually be included in the FSA, though there were some difficulties in the legislation. He expected these to be tackled with the co-operation of Lloyd's.

The Governor said that the arrangements between the Bank and the FSA had been handled extremely well and had not been at all easy. He thanked the Deputy Governor, Mr Foot and Ms Lowther for all the work they were doing to make it go smoothly.

Turning to the paper by the Traded Markets Team, Mr Foot said that this team was one of the real centres of excellence developed in the last couple of years. Introducing the paper, Mr Bereza said there were 11 members of the team, who had made more than 300 visits in the last three years. Work on banks was a continuing process which must respond to changes in products, control systems and people. It provided a vantage point for analysing good and less good practices on risk and for defining sound practice in certain key areas, to be promulgated more widely. It also gave broad insights into institutions, particularly their management of risks. In reply to a question from Sir David Scholey about whether individual transactions were tested, Mr Bereza said that while this was not generally the case the team would identify and look at individual transactions as illustrative of the risk management process. In response to another question by Sir David, Mr Page said that there were frequent meetings with overseas regulators (including the United States) on issues identified on TMT visits. Mr Buxton commented on reports that the regulators were not keeping up with industry developments; he noted a G30 report suggesting that this was a problem in the United States. The Governor said this raised very big issues about the future of regulation but, in relation to the rest of the world, he had the impression that the Bank of England was as well up with the game as anybody. In reply to a question from Dame Sheila Masters, Mr Bereza said that quite a large number of major institutions were not operating in line with minimum standards across all their activities. In reply to a question from Sir David Lees about interfaces with audit committees in this area, Mr Foot said contacts had been growing in the last 18 months, though for reasons of corporate governance some major banks were still reluctant to let the chairman of the audit committee come alone to meetings. That was something that was being tackled.

Turning to the situation in Asia, Mr Wright said that Yamaichi Securities had a UK incorporated bank which was able to meet its obligations provided other banks behaved. It had been agreed that there would be an orderly winding down, with restrictions, and the target was a licence surrender date of

June 1998 (though there was still considerable flexibility in this).

On wider issues, the Japanese authorities had made a number of supportive statements at the time of the announcement about Yamaichi Securities and had been lending to Yamaichi and other parts of the system experiencing market difficulties. The Bank of England had been involved in sorting out market difficulties in London, and this had worked very effectively. It was done in close collaboration with the Financial Services Authority constituent bodies, and the Japanese authorities. It had been a good exercise and one lesson was clear, the need for good mechanisms for effective collaboration in future, including good communication links. Mr Wright noted three major problems for the Japanese financial system: the economy was very weak; Japanese banks' exposure to indigenous South East Asia entities was thought to be $80bn, and there was still a major problem of credibility over the size of the bad debt problem, and the possibility of more tobashi losses. There had been a modest, though welcome, package of tax cuts amounting to 0.6% of GDP. Unofficial estimates were that total bad debts may be Yen 80 trillion. If taken at face value that would be more than 10% of banks' lending.

It had become increasingly clear that there was a need for government measures in three areas. A number of banks were in a parlous condition, and a large recapitalisation might be needed. There was a need to replenish the deposit insurance fund if banks were to be allowed to close but depositors to be protected. And credible figures were also required on the bad debt problem. A statement the day before by the LDP, the governing party, had been extremely disappointing, because there was no firm action at all in these areas. Premiums on loans to Japan had as a result picked up.

Turning to Korea, Mr Miles said there were 10 branches and three subsidiaries of Korean banks in the UK, with most of their lending to Korean companies, though one also had expatriate retail deposit business here in London. Since the Spring, they had been monitored very carefully and staff had made two visits to Seoul in the year. Quarterly meetings had been continued with the Bank of Korea, and there were continuing contacts with the Bank of Korea and the Korean Embassy in London. Currently, there were daily reports on the Korean banks' funding positions, and the Bank was exchanging notes with supervisors in the US, and had contacts with the IMF and the Bank of Japan. Mr Miles said we had also established a reasonable link with the Bank of Korea in Seoul. It was about the worst time to have a crisis because of the political calendar, with the elections due the day after the Court meeting. It was hoped that there would be a firm statement of support for the IMF programme by whoever won. Korea had promised a number of structural changes including floating the exchange rate, removing the interest rate ceilings, restructuring industry, restructuring banking supervision and other financial regulation and admitting more foreign capital into the country. However the situation was currently on a knife edge and the outcome would depend on political developments. The situation was being watched very closely.

In reply to a question from Mr Buxton, the Governor agreed that in the light of their problems, the Koreans had not been able to focus properly on the World Trade Organisation negotiations.

EMU and Year 2000 Projects

In introducing a discussion, the Deputy Governor said that over the last two months the Bank had carried out a major review of its internal preparations for EMU and the Year 2000. This had been put to the Audit Committee on 2 December. The announcement by the Chancellor in October about the EMU timetable had clarified what the Bank was aiming at. The work of preparing for EMU was very important, and the Bank, which was at the centre, must itself be ready. Mr Plenderleith had taken day-to-day responsibility for this in the last few weeks, and there had been a marked step up in pace. On the Year 2000 computer problem, work was being done in the Bank's departments, and every department should be compliant by the end of 1998, with 1999 for testing. This would be reviewed every three months. While the conclusion was that the Bank was on track, it was not complacent and it was dependent on key information technology people and managers. There had been discussions about the extent to which the Bank could induce them to stay. The Audit Committee had been quite concerned about the budget and had made clear the importance of not taking on any other projects without having studied the resource implications. The Committee had asked the Bank to come back and bring it up to date in April.

In reply to a question from Mr Neill about whether the issue of embedded chips had been taken into account, the Deputy Governor said each department had been asked to identify where it could and could not cope. Mr Neill said it might be worth asking them that particular question. He gave an example of forklift trucks, where the chips had a date code and the machine might assume it was not maintained and shut down at the millennium date. The Governor said that the point was taken and the specific question would be asked. In response to a question from the Governor about the Audit Committee's views, Sir David Lees said that the Committee was very pleased with the progress that had been made by Mr Plenderleith and the Deputy Governor. The embedded chip point went back to the Printing Works in the main, and the Committee had discussed the need to go back through supplier chains to establish the precise nature of the problem with embedded chips used as components of equipment. He also noted the importance of keeping a very close eye on the human resources required, since the Bank was dependent on relatively few people.

A Report of the Audit Committee

Sir David Lees, in his capacity as Chairman of the Audit Committee, drew attention to a number of points in the draft minutes of the Committee's last meeting. Since that meeting, the question of bonuses and retention of staff had been discussed by the Bank. He noted a number of other issues that had been discussed by the Committee but said that there was nothing to alarm Court. On Court's behalf, the Governor thanked Sir David, Mr Simms and Dame Sheila Masters for their work on the Audit Committee and said it gave him great reassurance that they were doing it.

EMU: the 6th broadly quarterly paper (Mr Collins in attendance)

Mr Plenderleith noted that 40,000 copies had been distributed of which 5,000 went overseas. Introducing the quarterly paper, Mr Collins said the Bank's leitmotiv over the past couple of years had been that the wholesale financial sector must be ready from the beginning of 1999 whether the UK was 'in' or 'out'. Its role in catalysing the preparations therefore continued as before. Preparations were on track for a euro wholesale payments system to be operative in the UK from the beginning of 1999. There was, however, nothing new to say on TARGET.

Notwithstanding the opt-out, London market practitioners were continuing to do a great deal to assist the practical introduction of the euro into the financial markets. This included pushing for legislation on continuity of contracts and on harmonisation of market conventions. The new area of attention was the so-called 'conversion weekend' spanning the end of 1998 and the beginning of 1999. Many trades and outstanding positions denominated in participating currencies would be transformed into euro units over that weekend, in a 'Big Bang'.

The report endorsed the recommendation that sterling should be quoted against the euro as 1 euro = £x, rather than the other way round. It also reported on the BBA's plans with regard to publishing euro LIBOR, and on latest developments with regard to EURIBOR, a proposed pan-euro area reference rate. In addition, it gave as much information as it could on plans for redenomination of government debt, which was urgently needed by market practitioners.

Beyond the preparation of the wholesale financial infrastructure, the Bank was monitoring many individual financial institutions' own preparation in the UK. 'Practical Issues' noted that thorough and substantive preparations were in hand amongst banks and securities houses, although preparations amongst many fund managers and insurance companies appeared rather less well advanced.

Finally the report noted the Chancellor's new Business Advisory Group and its various sub-committees.

A symposium would be held in the Court Room on 20 January to promote the theme that London would be ready in 1999 as the international financial centre for the euro; and the Deputy Governor would be leading a series of international roadshows shortly after to spread the same message abroad. The Governor thanked Mr Collins and asked him to thank Mr Townend on his behalf. Mr Buxton said that it was a very useful report, filling a gap in the process and getting everyone moving.

The Executive Report

(i) Korean Loan

The Governor said that as part of the International Monetary Fund's support for Korea the UK was asked, with the other G7 Governments, and now the G10, to provide second stage support. The UK's share was $1.25bn. This would be on the Bank's balance sheet but not at the Bank's risk because it would be fully covered by government guarantee.

(ii) Format of 1997/98 Annual Report

Turning to the 1997/98 Annual Report the Governor said that legal advisers, including the Treasury Solicitor, had confirmed that since the Report was on the year before the Act was changed it would be on the same basis as before, so there was no need to put in hand special arrangements for the Non-Executive Directors to produce their own part of the Report, as required under the Bank of England Bill.

(iii) Declarations on appointment to Court

Turning to changes in the Charter, the Governor noted that there was a question about whether to continue the declaration to the Governor by Members of Court. The current thinking, with which he agreed, was that the declaration would be retained but it would cease to have legal effect. It would be a formal act, with no legal consequences. The feeling had been that it was part of the Bank's tradition and that was the basis on which the new Charter was being prepared, if Court was content. <u>Court was content</u>.

(iv) Abatement of Pensions

The Deputy Governor proposed that the practice of abating the basic state pension against the Bank of England pension would cease on 1 March 1998 at a cost of £18mn. He noted that the Pension Fund had a surplus of £195mn. Mrs Heaton confirmed that the Trustees were aware of this and were content. The Deputy Governor said that the intention was to announce this in the next day or two. One reason was that the Financial Services Authority was going to announce the terms of its own pensions and the Bank would like to be on all fours with them. Mr Buxton said it was an important relaxation, since the benefit was quite large. He asked whether it would be taken into account in salary negotiations. The Deputy Governor said the Bank had been pressed for a long time and very hard by the Union and would claim any concessions it could from the Union. It could have been delayed until the Union negotiations but it was thought best to do it at the same time as the Financial Services Authority because otherwise there would be serious difficulties in the transfer of pensions to the FSA. The

Governor noted that it was a concession that impacted on people on lower rather than higher pensions most severely and he welcomed the proposal to make a move at this stage. Court was content with the proposal.

(v) **Forex swaps on the Bank's balance sheet**

Mr Plenderleith introduced a proposal for the Bank to undertake foreign exchange swaps on its own balance sheet. Foreign exchange assets and liabilities were already on the balance sheet on a matched basis. The Bank would like to extend slightly the nature of foreign exchange operations using the flexibility the Chancellor had given it. The reason was the management of the sterling money market. There would be exceptionally large temporary shortages in January and February because of a very large government surplus, and this would be reversed in March. The Bank would deal with this principally with repos but, because of the scale of the flows, it would be useful to have a second instrument available. It would buy foreign exchange swaps against matched forward transactions. It was a perfectly normal central banking operation, and had been done regularly in the past using Exchange Equalisation Account funds. But it was not an operation the Bank had been able to do with its own funds. There would be no foreign exchange exposure because it would be matched the whole time. It would involve credit exposure but there were limits in place and, in any case, the shortages themselves would bring credit exposures. The procedure would be a useful extension of techniques available to the Bank. It was also on the list of techniques proposed by the European Monetary Institute and could be seen as a step towards standard central banking practice. It would show up in the monthly statement of government foreign exchange holdings but only as spot transactions, and the Bank would have to explain that these were matched by forward sales and there was no increase in exposure. He asked Court's approval for up to £2bn, in January and February, to be reversed in March.

Sir David Cooksey asked whether this straddled the Bank's year end. Mr Plenderleith said that it would mean that proposals for foreign exchange position valuation, which had been discussed with the Audit Committee, would need to be implemented before the year end. Sir David Lees commented that the important point was that there was no open exposure. The Governor noted that it was essentially a technical change with no foreign exchange risk and no credit risk that the Bank would not otherwise incur. The Bank would look into Sir David Cooksey's point and if it was significant would report back in January. He noted that the Court had approved open exposures at the request of the MPC but had not used them.

Mr Buxton noted that Court had discussed credit limits some time ago. He asked whether the Audit Committee was doing a review of the risks undertaken by the Bank in relation to its capital. The Governor replied that this had been taken on board and the Bank would be coming to Court through the Audit Committee with proposals for establishing credit limits. The. credit limits paper would be shown to the Audit Committee before it came to Court, probably in February. Dame Sheila Masters said that the Committee would be interested in the information systems for monitoring credit limits.

(vi) Year 2000 Group

Turning to City institutions and the millennium problem, Mr Clark noted that, in association with the British Bankers

Association and the Financial Services Authority, a meeting had taken place last month to take stock of preparations in the City. There were three main issues. First, there was some concern to establish harder benchmarks. There had been discussions since the meeting about how these could be constructed. Second, it would be difficult to feel comfortable until there had been some serious system testing. This was not straightforward and the options were being investigated with some of the major infrastructure providers in the City. The sense of the meeting was that it would be helpful to do this in 1999. Thirdly, there were many groups involved in the Year 2000 problem and there was a feeling that there should be some way of bringing them together and exchanging information. So the group would continue to meet in a modified way. He envisaged that these meetings would be monthly or two-monthly during 1998 and through into 1999. He also noted that the FSA was looking at the issue from a regulatory point of view.
Sir David Cooksey said that an overview of the situation by auditors was helpful to individual companies. In reply to a question by the Governor, Mr Clark said that auditors fought shy of any general assurance that the firms that they were auditing were not going to encounter problems. This was why a hard benchmark was needed. The Governor asked whether this would set out best practice and the auditors would then ask themselves whether the company had complied or not. Dame Sheila Masters said that auditors were concerned about underwriting the Year 2000 compliance, which they would not like to take on. Mr Buxton noted that a class action had been filed against information technology companies in the United States in this regard. Mr Clark noted that the City Disputes Panel was already drawing up a standard disputes procedure.

New Framework for Bank Officers (Ms Lowther in attendance)

Ms Lowther said that the key features of the new framework were a single integrated grading structure for all banking staff, clear career routes which, through job families, would reflect individuals' increasing application of knowledge and skills, pay related to individuals' value and contribution to the Bank, and structured training and development, to support the acquisition of core skills, specialist skills and knowledge.

She described a benchmarking exercise which had produced three separate job groupings. These were jobs expected to be undertaken by staff in their early years in the Bank - around 20% of the benchmark sample - which would form a training band, salary band 7; a broader group of jobs which the majority of staff would undertake - around 70% - in salary bands 6 and 5; and a group of jobs identified as equivalent in size to those being undertaken by officials - around 10% - who would be in salary bands 4 and 4T. She also described the job families. These were information services, business support services, banking services and a technical grouping which related to a small number of individuals with specific technical expertise. The new arrangements would provide a clearer focus for staff and their managers to discuss career progress and career management. The thorniest area was pay. A significant percentage were overpaid and a significant percentage were underpaid. The underpayments were relatively easy to deal with but overpayments were rather more difficult and would have to be managed over time. The Bank was not going to cut salaries with the new framework, but would freeze above a certain level, and above that level cash bonuses not salary increases would be offered as rewards. The Bank had put a lot of effort into communicating the new arrangements. They had been received pretty well. However, there was a fairly high degree of scepticism among staff because they had been subjected to a high degree of change. One achievement was that there was now a readiness to listen and an understanding that the Bank did mean it. Line managers had been briefed and the new system would be implemented by March.

In reply to a question from Mrs Heaton, Ms Lowther said that job families only applied in Bands 5 and 6 and not further up. In reply to questions by Mr Allsopp, Ms Lowther said age and length of service scales would go and pay would be very much more linked to what an individual contributed to the organisation. She did not know the precise number in information services but believed it would be 400 or possibly more. Mr Buxton asked what the Bank was doing to train staff in assessing other staff. Ms Lowther said there had been an appraisal system (and associated training) for a considerable time but she agreed with Mr Buxton that, because there was some automatic element in salary increases, appraisal affected a relatively small part of the income of this group of staff. This was something the staff themselves were concerned about but she was determined to keep responsibility at local management level. However local management must be able to justify and explain the basis for decisions to individuals and to their peers. So there would be arrangements for monitoring. Mr Buxton suggested that the Bank would find that payments clustered around the mean. Ms Lowther said that Officials had the same arrangements, and the Bank had similar qualms, but it found the outcomes more differentiated and the managers themselves liked the system better than the Bank had thought they would. Mr Simms said he would have liked to have seen the document in advance because it was one to which Court could have a reasonable input. He also asked whether grading would be secret. Ms Lowther said that the Bank did not intend to broadcast every individual's position within a grade but everybody would know where they were. The distribution of jobs between grades would also be available to all who wanted to see it.

Mr Neill asked whether the Bank was a member of the Investors in People scheme. Ms Lowther said the Bank aspired to that status and the new framework took the Bank towards the point at which it could make a commitment, but it was not there yet.

Court approved the proposals as outlined.

The Governor thanked Ms Lowther and her staff for the terrific effort that had gone into the Bank Officer Review. Ms Lowther left the meeting.

Sir David Scholey said it was a difficult and excellent decision to replace the previous incumbent with Ms Lowther. The Deputy Governor also praised Ms Lowther's performance and said she looked and sounded like a modern human resources professional. He said he was conscious that her career aspirations were to get back into the front office operations of the Bank.

Court Succession

The Governor said he would leave papers, which were in Court folders, with Members and invite their comments outside the meeting though, if they had comments in the meeting, he would be very pleased to receive them. He noted that, sadly, the Bank was taking its leave of Sir David Scholey and, also, Sir

John Hall had said he would like to step down at a convenient moment. His health was not good. The papers included a matrix showing the existing Court, and a large number of prospective members based on recommendations by the Agencies, and other lists including possible women candidates. He said he was bound to say that it was very hard to come up with names and he would particularly welcome additions to the lists. He said that the Bank's understanding was that existing Members of Court would be re-appointed for the balance of their unexpired terms. He said he hoped that Sir David Cooksey and Dame Sheila Masters would wish to serve again and that the government would agree to reappoint them. With Mr Howard Davies' appointment to the Court already decided, there was a requirement for four new members of Court when the Executive members left, together with two retiring Members and the addition of Mr Davies. The net result was that the Bank was looking for five new Members of Court.

Court had always taken the view that it would welcome a trade union member and he believed that was something the new government would agree with. The feeling among the Executive was that John Monks would be an outstanding member and if he were proposed, the hard question was whether that would raise the appointment of representatives of other groups. If that path were followed, would it mean that, ex-officio, the CBI and other organisations would provide members of Court? He asked Court to reflect on that point. It was not inconceivable that there would be more than one trade unionist. Mr Allsopp asked about reports in the newspapers that Bill Morris of the Transport & General Workers Union would be appointed to Court. The Governor said he had heard no suggestion about that other than a report in The Guardian. He did not know whether there was any substance to it, and so it could be disregarded for this purpose, but he was clearly a potential member. The Governor said he expected to send a letter to the Chancellor suggesting names for Court early in the new year, as usual.

Mr Buxton asked what was meant by the government wish that there should be more regional representation on Court. The Governor said that it was quite clear that the government wanted somebody who spent a lot of time in Scotland, for example, and probably also Wales and arguably Northern Ireland. He had a good deal of sympathy with what the government was seeking to do.

Recommendations from the Remuneration Committee

In accordance with Section 10 of the Charter, The Deputy Governor and Messrs Plenderleith, Foot and Clark withdrew. Sir David Scholey, in his capacity as Chairman of the Remuneration Committee, said that the Committee had met twice recently to consider the remuneration of the Governors and Executive Directors and it was recommended that, with effect from 1 January 1998, the following enhancements to remuneration should be made:-

(i) Mr M A King from £145,000 pa to £190,000 pa

(ii) Mr I Plenderleith from £140,000 pa to £150,000 pa

Having reviewed the remuneration of those parties carrying the title Advisers to the Governors, it was recommended that, with effect from 1 January 1998, [redacted].

In addition, it was recommended that [redacted]

Sir David Scholey also pointed out that last August, Court approved the remuneration for Dr DeAnne Julius at the level of [redacted]

<u>The recommendations were approved.</u>

Sir David Scholey said that in January he would be bringing some unfinished business from 4½ years ago to Court. This was the Governor's pension arrangement and papers had been circulated to Members of the Remuneration Committee. Sir David said that it was important to deal with this before he retired from Court because he and Sir David Lees were the only remaining members of the Committee from that time.

The Governor thanked Court for its support during what had not been an easy year. Sir David Scholey commented that the Governor fully deserved the support of Court.

21 January 1998

A MEETING OF DIRECTORS AT THE BANK

WEDNESDAY 24 DECEMBER 1997

Present

Mr George, Governor

Mr Clementi, Deputy Governor

Mr King

Mr Plenderleith

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

D Clementi

21 January 1998

A MEETING OF DIRECTORS AT THE BANK

WEDNESDAY 31 DECEMBER 1997

Present

Mr George, Governor

Mr Foot

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 Meeting, having been circulated, were noted.

21 January 1998