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A COURT OF DIRECTORS AT THE BANK

WEDNESDAY 17 JUNE 1998

Present:

Mr George, Governor

Mr Clementi, Deputy Governor - Financial Stability

Mr King, Deputy Governor - Monetary Stability

Dame Sheila Masters, Chairman, Sub-Committee of Directors

Mr Allsopp

Mr Bailie

Mr Buxton

Sir David Cooksey

Mr Davies

Mr Hawker

Mrs Heaton

Sir Chips Keswick

Mr Morris

Mr Neill

Sir Neville Simms

Sir Colin Southgate

Mr Stretton

In accordance with Schedule 1 Paragraph 13(5) of the Bank of England Act 1998, and a request from the Governor, the Governor and the two Deputy Governors absented themselves and in accordance with Paragraph 13(3) of the above Schedule, Dame Sheila Masters took the Chair.

A Recommendation from the Chairman of the Remuneration Committee

"The Committee proposes that the Governor's base salary of £227,000 (his salary fixed in 1993 plus the Court fee) should be increased from 1 July by 2.5 per cent, the same percentage as the

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Government's inflation target. The increase in each future year of his new term of office would also be in line with the inflation target.

The Committee notes that the Governor surrenders to the Bank all entitlements for services on behalf of the Bank.

The Committee proposes that the Governor should be paid an ex-gratia pension on retirement, worked out on the basis of the difference between his Court Scheme pension at 60, calculated without the BIS pension, and two-thirds of his final salary on retirement based on the proposal above. If the Governor retires after five years and his salary is increased in line with an inflation target of 2.5 per cent each year, the ex-gratia pension would be approximately £13,000.

It is proposed that the Governor should continue to have a death-in-service benefit of four times his salary during his new period of office. The Bank should also provide a widow's payment of five times pension, with the same terms and duration as in the Court Scheme. But the five-year term should commence when the Governor leaves the Bank rather than when he leaves the Court Scheme.

The Committee notes that the Governor will leave the Court Pension Scheme on his 60th birthday, and that his deferred Bank pension would thereafter increase each year until drawn, to reflect that deferment."

Sir Colin noted that when the Governor took over his pay was fixed at £227,000 a year and that had been the final year of pay of the previous Governor. The Remuneration Committee had discussed whether to look retrospectively at the figures but Sir Colin said that the Governor had been adamant that he did not wish to do so and he had been very keen to associate himself with the inflation target. He also noted that the Governor would be 60 in September and a line would be drawn under his pension. The Bank would not make any more contributions through the Court Scheme. His pension would be left in the Scheme and would be inflated by actuarial calculations until the date at which he retired. Sir Colin also drew Court's attention to the proposals for continued life cover and for a widow's payment of five times pension, commencing when the Governor retired rather than when he reached the age of 60. Finally he

drew attention to the proposal for an ex-gratia pension. Sir Colin noted that the Remuneration Committee had been unanimous and that the recommendation set a tone that the Governor himself wanted to set to the public at large about earnings.

Mr Buxton said the salary proposal was very sensible from the public relations point of view. But he believed that it would have been fairer to have recommended a pension inside the pension scheme rather than an ex-gratia payment. Sir Colin Southgate noted that it would be funded annually or in one lump sum and his preference was for it to be funded out of next year's profit and loss account. Mr Buxton agreed with the proposal in the light of that fact. Mr Stretton and Mr Neill expressed support for an ex-gratia payment. Mr Neill said that if the Bank went into the market place to find someone of the Governor's calibre he doubted whether the starting salary would be the same as in 1992, and it was a great credit to the Governor that he was happy to accept the figure proposed. Sir Colin also noted that the Governor wished it to be made clear in the Annual Report that any fees and pension paid by the BIS attributable to his position as Governor would be surrendered to the Bank. Sir Colin noted that most Governors continued to serve with the BIS after leaving the Bank, but that was at the discretion of the new Governor. As was the case with the previous Governor, who continued as a Vice-President at the BIS, the fee would become payable to him personally after retirement from the Bank.

The recommendation was APPROVED.

The Governor and the Deputy Governors joined Court and the Governor took the Chair.

The Governor thanked those Members who had made their declarations on appointment/ reappointment to Court this month, before the Meeting commenced, to Mr Clementi; he also congratulated Dame Sheila Masters on her appointment as Chairman of the Sub-Committee of Directors, Mr King on his appointment as a Deputy Governor, and he extended a warm welcome to Messrs Bailie, Hawker, Morris and Stretton on their first attendance at Court.

The Minutes of the Court of 13 May and the Meetings of 20 and 27 May, having been circulated, were approved.

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A Report of the Trustees of the Court Pension Scheme

Turning to the Report of the Trustees of the Court Pension Scheme, the Governor, having declared his potential interest in the Scheme together with those of Messrs Clementi, King and Davies, invited Sir Colin Southgate to introduce his Report which contained the following recommendations:

(a) The annual pensions in payment to former Governors and Executive Directors and allowances to the widows of former Members of Court be increased, with effect from 1 July 1998, by the amount of the increase in the Retail Prices Index for the twelve months ended 31 May 1998.

(b) similar increases be granted from 1 July 1998 to:

(i) the ex-gratia allowances payable to Lord Richardson, Sir George Blunden and Lord Kingsdown;

(ii) the ex-gratia payments awarded to widows of former Members of Court who retired prior to 1978 and whose allowances were based on their husbands' pensions net of commutation;

(c) the annual allowance paid to Lord Richardson from the Court Pension Scheme under special arrangements which were approved by Court on 10 February 1983 be increased in accordance with those arrangements.

Court APPROVED the recommendations.

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Economic and Monetary discussion (including market charts); together with the International Economy (Messrs Vickers and Plenderleith together with and in attendance)

In introducing the discussion Mr King said there continued to be a tale of two economies. It was necessary to bring down domestically-generated inflation before the one-off benign effects of the higher exchange rate and low commodity prices wore off. The minutes of the meeting of the MPC on 13 May revealed that six members had voted for no change and for the first time one had voted for a decrease. One had voted for an increase. Monetary policy remained finely balanced. Mr King said that he had noted at the time that the path of interest rates would depend critically on the speed at which domestic demand slowed, the path of the exchange rate and the pace of earnings growth. The Inflation Report had flagged the fact that the decision on interest rates would depend on these three factors and the increase in June should not have been as much of a surprise as it was. He noted that, since the increase, the Government had published its report on fiscal policy, and the MPC would be briefed on this before the July meeting. The exchange rate had also started to move up again, and new inflation and labour market data had been published. Turning to the financial markets, Mr Plenderleith said there had been a good deal more movement in nervousness recently, associated with the Asian crisis, the weakening of the Yen, developments in Russia and pressures on additional regional centres such as South Africa and Australia. He drew particular attention to the movements of the pound in chart two. He also noted the tightening in money market rates which had risen about 60 basis points compared with the 25 basis points rise in official rates. There was greater recognition of the upside possibilities for interest rates.

Mr Allsopp asked whether Court could have a paper on what the concept of domestically-generated inflation meant, and how the different inflation measures fitted together, with charts. The Governor agreed to the production of the paper for Court.

Mr Bailie commented that there was very little inflation in manufacturing. Most manufacturers had no choice but to finance pay increases from productivity. The only other way was through absorption in profits. He asked what had been the deflationary effect of the rise in interest rates since 1995, what had been the impact of the higher exchange rate and what was the sustainable exchange rate against the German Mark. Mr King said he was not sure anyone could provide a figure for the sustainable rate against the Mark. He also commented that if there had been no

interest rate increases in 1994 and more recently, then domestic demand growth would have increased more rapidly leading to greater inflationary pressures. What was happening was not a boom like the 1980's. What had been seen since 1992 was above trend growth, which was continuing too long to be sustainable. There was absolutely no doubt that the biggest problem was the disparity between the impact on manufacturing and exports, and the domestic economy - the tale of two economies. Mr Buxton commented that there was no doubt that the economy was slowing a bit but there were no signs of particular strain. There were difficulties for the agricultural and exporting industries but other indicators such as corporate bankruptcy, liquidity and the affordability of houses showed a pretty comfortable position. The economy was slowing but there was still plenty of fat in it. Turning to publicity for the workings of the Monetary Policy Committee, Mr Buxton commented that there was still a lot of ignorance about the way the MPC worked. The more members of the Committee talked about the way the Committee worked and the amount of time spent before a decision was taken, the better. It was particularly important for the business community to understand that the decision was not taken on the spur of the moment after five minutes thought.

In response to a question from Mr Buxton about the 2.75% real increase in spending announced by the Government, Mr King said the Bank did not know whether this would put pressure on inflation because the definitions of public expenditure had changed in a way that made it very difficult to make exact comparisons. The Bank was talking with the Treasury and working with officials to make the comparisons in time for the next forecasting round. The Governor commented that it was not thought there would be a significant impact in the short-run over the next year or two.

Mr Morris noted four points. He asked whether the Bank had measured the correlation between earnings growth and productivity. His view was that if productivity was rising to the extent that unit cost pressures were reduced, the problem was less. Second, he said he was surprised that there was insufficient data on bonus payments. If so, were any steps being taken to correct this? Without this he did not see how there could be public confidence in the debate about the minimum wage. Third, he asked to what extent announcements by the MPC could be used to lead the debate and influence behaviour in wider decision-making forums. Fourth, he commented that it would be helpful for Court Members to be informed at about the same time as public announcements were being made. The Governor said that the Bank could

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certainly do that. Mr King said that the Bank would make sure that those Members of the Court with E-mail addresses would get E-mails about announcements as they came out. Turning to bonuses, Mr King said that the Bank had talked to the ONS and asked for more data. The puzzle was that bonuses in manufacturing appeared have gone up more than elsewhere, but it may have been a reflection of partial data. It would still be quite difficult even with more information to work out the implications for costs and pricing. The link between earnings and productivity was difficult. From an MPC perspective what mattered was average earnings and average productivity. On average there was almost no growth in productivity. The inflation implications hinged very much on average productivity growth in the economy as a whole and average earnings growth.

Sir Neville Simms said that in the construction industry the evidence was a little more mixed. There were now beginning to be signs that though the pipe-line was pretty full for the next couple of years the picture was not so clear with new activity. Pay pressures were still more focused on London and the South East because of a shortage of particular skills in particular areas. The industry as a whole may be slowing but it needed another couple of quarters to tell. Mr Davies noted that the FSA was actively recruiting and in most sectors of the financial business wages had moved ahead more rapidly than had been expected. There was no sign of peaking. In response to a note of caution from Sir David Cooksey about the figures for manufacturing and services wage inflation, Mr King said that if the official figures were to be believed, manufacturing earnings were growing at 5.6% and services at 5.3% of which private sector services were 5.6%. Mr Neill noted that while in May car sales had risen 1.7%, in the first 10 days of June there had been an increase of 21%, and although the figures were erratic this was surprisingly high. Mr Hawker noted that in information technology there was a scarcity of a whole range of skills, and this would feed through to inflation. He had no doubt that the removal of profit-related pay was also putting pressure on pay settlements. Mr Stretton said that he had no doubt that there was a great variation in the macro-economic numbers for pay. Information technology and other shortages in financial services had led to increasing discussion of market-related pay, and were blowing apart pay structures.

Turning to the international economy, Mr Vickers introduced a paper by [redacted] He noted that the paper drew out some of the similarities between US and UK macro-economic developments since 1995, which led the US Federal Reserve to face many of the same issues

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currently being addressed by the MPC in determining the optimal path of monetary policy. While commenting on a number of similarities, he noted two key differences between the US and UK, in that US headline consumer price inflation had fallen since 1995, in contrast to the UK, and in the US, industrial production growth had been far stronger than in the UK, and only began to slow in the first quarter of 1998. The Governor thanked [redacted] for an extremely interesting paper.

Mr Neill commented that costs could come down forever if the right skills and technologies were available. The UK as a whole did not believe this proposition, but large parts of the United States did. The Governor noted that he had heard similar arguments elsewhere, including from Mr Greenspan. Dame Sheila Masters said that she had recently met Mr Brash, Governor of the Reserve Bank of New Zealand, who was a one man monetary policy committee because he made the decisions. She was struck by the huge effort he and his colleagues made to go out and explain them. She commented that New Zealand was more pro-active in getting these messages across. Mr Davies noted that there were fewer people in New Zealand. Sir David Cooksey commented that in the US a 6-year boom in the economy had never been accompanied before by falling commodity prices. He also noted that the paper talked about the relative importance of industrial production in the US and the UK and questioned whether there was a problem of industrial classification. Much of the productivity increases in the US came from the new knowledge-based industries. Mr Vickers noted that the differences in investment performance were quite striking. The capital invested per worker was of the order of 50% more in the US than in the UK. He commented that this was a long-term issue. Ms Webb noted that the prevailing view among Federal Reserve economists was that the jury was out. Investment growth rates were impressive. The view of Mr Greenspan that the role of information technology was very important was widely shared. But at present Fed economists were waiting for more data. Investment was strong but productivity growth was beginning to slow. This fitted in with the view that it was no more than a cyclical upturn supported by strong information technology growth. She noted that she had been told informally in Washington that another year of good productivity numbers would start to shift views. Mr Allsopp commented that Mr Greenspan's views could be interpreted as hoping for a slowdown that had not happened. The Governor commented that Mr Greenspan might feel rather inhibited about taking action.

Credit Risk Management in the Bank (Mr Plenderleith and Ms Hayes in attendance)

Mr Plenderleith introduced his paper, which focused on credit exposures arising from the Bank's normal operations, how such exposures were controlled and monitored, and the programme to improve the control process. He noted that controls were in place in line with the policies adopted by Court. The next step was to develop reporting on a real time basis. Once OpenLink was operational and IT resources could be freed from work on the euro and Year 2000, work would be undertaken to develop a more comprehensive and timely report of the Bank's aggregate credit risk exposure to individual counterparties across the whole of its operation. At present each area received daily reports from credit risk management, and they were pulled together to show the aggregate position once a quarter. That said, the Bank could, when necessary, establish its aggregate exposure to a problem counterparty by the start of business, as was demonstrated for Barings.

Mr Davies noted that in relation to the FSA, there always had been a Chinese wall in banking supervision in the Bank. In the Memorandum of Understanding, that had been maintained. He said he would support the investment to upgrade controls and he noted the benefits of moving to real time reporting. These benefits could flow into the Financial Stability area, which could pick up signals from the market in this way. He said he would support the investment as soon as it could be sensibly managed within the IT programme of the Bank. Mr Buxton asked whether there had been any credit losses in the last 10 years, and whether there were any credit guidelines for the 220 banks with which the Bank dealt. He also asked whether Mr Plenderleith was sure that the Bank could not set credit limits for Bills, because he believed that there should be limits on the banks that had accepted Bills. Dame Sheila noted in Sir David Lees' absence that the Audit Committee had taken a considerable interest in this area and would strongly support improvements. The Committee had been concerned that these improvements had not come through more quickly. Mrs Heaton commented on the need for careful handling of the removal of weaker names from the Bank's list of counterparties to avoid market instability; she also asked about the frequency of breaches of limits. Mr Plenderleith, responding to the question about credit losses, said that in the case of Barings the Bank did face a potential loss but the Bank had relied on very high credit standards and the

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Bills concerned were paid off by the companies that drew them even though the acceptor did not.

Turning to individual banks credit limits, Mr Plenderleith said all those banks to which the Bank was exposed were looked at regularly by CRAC. There were five internal ratings which determined the limit of exposure to particular banks. On the question of limits on eligible Bills, the Bank set limits on the acceptor of eligible Bills and would not deal beyond that. The effect was that in the market the Bills were all traded as of the same quality and price. If new limits were set with the Bank as well it would mean that at certain points there would be tiering of names, visible from the market, because there would be credit differentiation based on the Bank's limits. He was cautious about doing that, not least because some of the names subject to limits would be the major UK banks, who would have filled their limits with the Bank elsewhere. Bills had three names backing them which was triple protection, though the Bank could look at limits if that was felt to be appropriate by Court. Turning to the withdrawal of names from the Bank's list of counterparties, he noted the importance of handling that issue carefully. The issue mostly concerned Japanese banks which had not been dropped from the eligible Bill list in a public way, because that would be a sign of deterioration, which could lead to a run. Rather, they had been approached privately, in co-operation with the banking supervisors and the Bank of Japan, and told that no public distinction would yet be made, but it would be helpful if they withdrew from the market. When the bank concerned eventually wound up its business its name could then be removed from the list.

Turning to breaches of limits, Mr Plenderleith said that in a very small number of cases breaches arose because the controls were not real time and, for example, the exchange rate might have shifted. This was not satisfactory. That was why the Bank had a programme of improvement with the immediate aim of moving to a real time system. Court's support for that programme was very helpful.

National Mortgage Bank plc (Messrs Davison and Kentfield in attendance)

Mr Davison gave a short presentation on events over the past year at NMB, and progress on the realisation of its loan book and other non liquid assets. He drew Court's attention to tables and charts he had prepared. He noted that NMB had brought proposals to Court last August for a possible sale but Court had decided to turn them down. The problems were finding a buyer prepared to pay a price approaching what NMB could get by running the loan book down itself and avoiding the risk that the Bank might be seen to be selling to an inappropriate buyer. Sir Chips Keswick commented that he hoped that the issue of selling NMB had been shelved. Mr Davison said the question was open. He noted the difficulty if the staff found due diligence work in progress, which might lead to the immediate prospect of a sale. Sir Chips commented that it was not for staff to object to potential buyers looking at the bank. Mr Davison noted that the bank was willing to consider an approach if there was a genuine prospect of a deal, but would not talk to people with whom there was no prospect of selling. The Governor said that if a reasonable buyer from the reputational point of view appeared, and made an offer close to what the Bank would get by running off the book, that would be looked at.

The Governor expressed his appreciation for Mr Davison's achievements with NMB.

Sub-Committees of Court and Non-Executive Directors' remuneration

With the introduction of the new Bank of England Act which came into force on 1 June, the Governor suggested that it would be appropriate for Court to delegate two of its responsibilities to sub-committees of Court; such delegation being permitted under Paragraph 11 of Schedule 1 of the Act.

The first delegation concerned the custody and use of the Bank's Seal and Paragraph 5 of the Act presented the opportunity to streamline the process without compromising the security aspects. The Governor added that under the Bank's Charter of 1946 and in accordance with a Resolution of Court of 5 March 1992 a Sealing Committee was established. But it was necessary for the Seal to be kept under three locks, the keys to which were kept by three Members of Court, and three Members of Court were also required to both approve the use of the Seal and attest its affixation. The Governor drew attention to a Resolution in Members' folders which proposed a much simplified process. If approved, the Secretary would have custody of the Seal; approval for the use of the Seal would rest with one or more Members of Court together with the Secretary; and application of the Seal would be witnessed by two Members of Court, or a Member of Court and the Secretary, or any two of the Governor's Adviser in the Legal Unit, the Deputy Secretary, the Assistant Secretary and the Manager of Court Post. A record of all orders of the Committee would be produced to Court twice a year. The Governor also noted that all documents requiring the application of the Bank's Seal were vetted by the Bank's legal advisers who provided written confirmation that the documents in question were in a fit and proper form for Sealing.

The Resolution was APPROVED.

Turning to the second delegation by Court, the Governor said that this related to determining the level of remuneration of the Bank's Non-Executive Directors. Whilst Paragraph 15 of Schedule 1 to the Act stated that 'a director of the Bank shall be entitled to be paid by the Bank such remuneration as the Bank may determine with the approval of the Chancellor of the Exchequer', the Governor pointed out that Court could not undertake this function whilst remaining quorate because interested parties would have to withdraw from the debate. He

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proposed that Court should delegate the authority to a sub-committee comprising the three Governors and drew attention to a second resolution in Members' folders to this effect.

Court APPROVED the resolution.

The Governor reported that he was still awaiting a response from the Chancellor on the levels of Non-Executive Directors' remuneration.

The Governor's Engagements

In line with custom and practice the Governor mentioned that Sir Robin Brook, who served as a Non-Executive Director from 1946-1949, would be celebrating his 90th birthday on Friday 19th June.

15.7.98

A COURT OF DIRECTORS AT THE BANK

WEDNESDAY 15 JULY 1998

Present:

Mr George, Governor

Mr Clementi, Deputy Governor - Financial Stability

Mr King, Deputy Governor - Monetary Stability

Dame Sheila Masters, Chairman, Sub-Committee of Directors

Mr Bailie

Mr Buxton

Sir David Cooksey

Mr Davies

Mr Hawker

Mrs Heaton

Sir David Lees

Ms McKechnie

Mr Morris

Mr Neill

Sir Neville Simms

Sir Colin Southgate

Mr Stretton

The Governor extended a warm welcome to Ms McKechnie on her first attendance at Court.

The Minutes of Court of 17 June, having been circulated, were approved.

Financial Stability work in the Bank (Mr Clark in attendance)

In introducing his paper which focused on three issues - namely the nature of the financial stability brief, the way the Bank was organising itself to meet its responsibilities under the brief, and the main financial stability issues currently on the agenda - Mr Clark said that in

general financial stability was less well understood than the monetary stability. In its broadest terms, it meant trying to ensure that the financial system maintained its capacity to perform its various roles. This involved: looking at the robustness of the financial infrastructure (which included the legal, regulatory, accounting and tax framework as well as the trading payment and settlement systems); surveillance, that is the monitoring of developments in the domestic and international financial sectors, so as to spot potential problems; and crisis management, in the event that something did nevertheless go seriously wrong. Mr Clark then pointed to the second part of his paper which described the structure of his Division and noted the planned growth in his staff budget. This reflected in part the need to develop the surveillance capacity to go beyond the information which the FSA could provide. However, he did not intend to reproduce the surveillance capacity which was transferred to the FSA but instead to have a small group of experienced staff who would focus on problem areas rather than attempting to monitor countries on a continuous basis. Current issues faced by his area included the crisis in East Asia; dealing with the computer millennium bug; the securities settlement review and the need to promote delivery versus payment in the securities industry; TARGET and its availability for London banks; the consolidation of exchanges both within London and across borders; and work on credit risks and how they should be taken into account by regulators.

Mr Clementi said that effort would continue to delineate the area's role and make sure it was clearly understood outside the Bank. Court would want to watch how the relationship between the Bank and the FSA worked in practice. The division of responsibility was clear, but there was a degree of overlap. Experience over the first few months had however been encouraging and relationships were good.

Mr Davies agreed that relationships were good and said the standing committee of the Bank, FSA and Treasury had performed a useful role in developing a systematic approach to current regulatory issues. On surveillance he said that there was a scarcity of good staff who could work in this area and it was important that there was not duplication between the Bank and the FSA.

Mrs Heaton pointed to the need for a programme of mutual secondments between the Bank and the FSA at senior levels in order to make sure that the good relationships continued. In answer to Sir David Lees, Mr Clark said that his staff were looking at a range of different indicators to

see whether the Asian crisis might have been spotted earlier; but he warned against expecting any infallible indicators. He noted that the IMF and others were doing post mortems on the Asian financial crisis more generally. The Governor considered the Asian crisis was a good example of the useful way in which the Bank, FSA and Treasury could work together, bringing together information from a wide range of different fora.

Mr Buxton noted that in London there were various organisations responsible for different parts of the financial infrastructure and wondered if that made it more difficult to pursue a clear development strategy. Mr Clark said that he thought it did; the Taurus project had failed because the Stock Exchange could not reconcile the various interests involved (although their failure had made it easier for the Bank's Crest initiative to succeed). Currently the Stock Exchange, LIFFE and Crest had their own agendas but the Bank had done a lot of work behind the scenes to co-ordinate their approach to the challenges facing London's capital markets.

In answer to Mr Buxton, the Governor noted the Bank had not set limits on the support it might give in a financial crisis as the nature of the support could vary as could the risks the Bank incurred. The Executive would seek Court's agreement if the Bank were to acquire particularly risky assets and the point might be reached where Court felt it was not appropriate given the size of the Bank's balance sheet. The Governor added that wherever possible the Bank would seek ex ante approval from the Treasury before adding to its balance sheet in a financial support operation. There was a question of how the Bank assessed the risks it undertook and the Executive would come back to Court on that.

Dame Sheila Masters said that Court needed a sense of when it would be involved in these judgements and the Governor said he would bring a paper to Court which would build on precedents such as the Barings case.

Mr Buxton congratulated the Bank on its persistence in achieving the deal on TARGET. The Governor said that there was a sting in the tail of the deal as remuneration under the ECB's facility would be at less than market rates and there might be a significant cost involved. Mr Clementi felt that the Bank had won an initial PR battle over TARGET as the press regarded the deal as a good result.

In answer to Dame Sheila Masters, Mr Clark said that the main players in the financial system were well prepared for the millennium bug but there were problems in preparedness abroad, particularly in the Far East where the question had not been fully addressed. There were also concerns about small and medium-sized companies outside the financial sector. Market nervousness about the millennium as that date approached could cause some financial instability as cash flowed between institutions according to beliefs as to how well they were prepared for the millennium bug. Ms McKechnie was disappointed with the Government's reaction to the millennium problem which initially had been slow and now ran the risk of repeating earlier work. She would welcome any pressure the Bank could bring to bear on the Government to improve its communications with the public on this issue. Mr Davies noted that the FSA had reserved the right to restrict the business of financial companies which had not done enough to prepare for the millennium and noted that the American regulators were particularly aggressive in that regard.

Mr Morris was concerned by the reported depletion of IMF financial reserves. Could the Fund maintain its current level of support for debtor countries? Mr Clark noted the Fund had activated the GAB in order to raise additional resources. Mr King said that the question was whether major creditor countries were prepared to put in more money to help the adjustment of debtor countries. The Governor noted the reluctance of U.S. Congress to contribute to further Fund financing or even to bilateral lending to which the US had agreed. Large bilateral loans to Indonesia and Korea had not materialised because of this reluctance.

Sir David Cooksey thought the question of financing small and medium-sized high-technology companies was an issue of growing importance and hoped the Bank would devote more resources to the subject.

Mr Clementi reported on the work of his G10 working party on equity risk in major financial centres. While there were concerns about the level of equity markets, there would be a greater concern if there were a bubble in property markets. The equity markets would be kept under close review but the conclusion of the paper was that no country needed to change its monetary stance in the light of the equity position.

Economic and Monetary discussion, including market charts (Mr Vickers, Dr Julius and Sir Alan Budd in attendance)

Mr Vickers, in introducing the discussion, noted that the minutes of the June MPC meeting, which had been published that morning, continued to show a picture of domestic demand growing above trend but with inflation restrained to some extent by the high value of the pound and the Asian crisis. The question remained, would domestic demand slow quickly enough to enable the inflation target to be met? The Committee had noted the strong earnings data and the pressure on inflation from the labour market. Eight members had voted to raise interest rates by 1/4 percent while one member voted to reduce rates.

Mr Vickers referred to the charts and drew attention to the unusually large fluctuations in recent weeks in the market's expectations for short-term interest rates.

The economic indicators in the last few weeks had been difficult to interpret because of unseasonable weather, the removal of last year's windfall effects and a possible World Cup effect on demand. That day's labour market data again showed a strong growth in earnings, particularly in the private sector.

Mr King noted that the June decision on interest rates had been unexpected, and therefore had a major effect on expectations. It had confirmed that the MPC was determined to meet the inflation target and was not behind the curve.

In response to Directors' comments, Mr Vickers noted that producer input prices had fallen by nine percent over the last year while output prices remained flat. There were clear regional variations in the earnings data but there were no figures on earnings growth in large companies as opposed to small companies. However, some sectors like IT showed particularly strong earnings growth.

Sir Neville Simms said he was more convinced that the construction sector was slowing and there was anecdotal evidence of a marked regional divide with the Midlands and South East remaining strong. However, wage pressures remained strong as the level of employment was at a six-year high. Sir David Cooksey detected a turn-down in the growth of small businesses

and thought that consumers were particularly price conscious and were looking for discounts in the summer sales.

Mr Neill was concerned that productivity in the UK was still much lower than in our overseas competitors. He welcomed the decision to raise interest rates as its showed the Bank's determination to get inflation down to target. Mr Buxton also saw the beginning of a downward trend among small businesses and said that banks expected a modest upturn in bad debts. Agriculture was a particularly depressed sector although personal lending was still rising rapidly.

Mr Davies thought that the interest rate message had not got through to human resource departments who were still bidding highly for staff particularly in the professions such as accountancy and law.

Mr Morris was worried that there was no national debate about productivity. We should be asking how productivity could be increased rather than exhorting over pay deals.

Dr Julius said that earnings were a lagging indicator of the business cycle and at a turning point would give a different signal than leading indicators. It was questionable how much earnings growth said about the future of the economy. Much of the effect of the monetary tightening over the last year was still in the pipeline and there were additional contractionary offshore effects.

Mr Hawker noted that water sales were falling significantly and energy sales were flat which indicated reduced economic activity. Sir Colin Southgate said that Court needed to understand better how the Bank would relate to the Treasury on fiscal policy.

Sir David Lees asked Mr Vickers to provide a note on the composition of the earnings data covering such aspects as overtime and productivity. Mr Vickers agreed to provide such a paper. Sir David Lees also wondered if there might be a case for the Agents mounting a special exercise on earnings growth.

Ms McKechnie noted that in the not-for-profit sector young graduates now wanted substantial salaries which indicated a cultural shift. Head-hunters seemed to be bidding up significantly the salaries of management.

In response to a question from Dame Shelia Masters, Mr Vickers said that the MPC was in the process of its quantitative examination of the national minimum wage, and that account would be taken of other labour market changes such as the New Deal and Working Family Tax Credit. These would be considered more fully in the August Inflation Report.

The Bank's Budget and Strategy, 1998/1999 (Messrs Clark, Vickers, Midgley and Footman in attendance)

Mr Clementi pointed out that the purpose of the paper before Court was to bring together for the benefit of new Court members the Bank's strategy paper an agreed budget; and to outline the Bank's strategic and financial objectives for the current year against which NEDCO would judge the Bank's performance at the year end. The paper set out the Bank's key objectives and restated the budget using the conventions Court had previously agreed upon. The critical documents for Court's review of the Bank's finances would be the Annual Report which would include the Executive's review of activities as well as a separate NEDCO report.

Mr Clementi noted that monitoring of performance was particularly difficult in a non profit based organisation. How could you quantify the extent to which the Bank had met its objectives in the TARGET negotiation? If we underspent on economists, was that good or bad? But as far as possible we had tried to set out specific measurable targets. There were areas where further work was needed and he referred to three matters. First, he acknowledged the paper was deficient in its treatment of income and said that he would come back to Court on how the Bank was organising its resources. Second, he indicated that Mr Midgley had begun work on considering how to bring together objective financial measures with subjective qualitative measures. Four tests should be considered: how well the Bank had met its financial targets; how well projects had been completed in terms of quality and time; how well the Bank's customers had been served, and the extent to which staff development had been achieved and its effect on recruitment and turnover.

Third, Mr Clementi said that Mr Footman, in conjunction with Mr Midgley, had been asked to produce a report for the October senior staff conference on how more objective tests could be established and how the Annual Report could be restructured to give greater accountability and transparency. Mr Clementi would come back to Court on these subjects in November.

Dame Sheila Masters was disappointed that the paper did not say more about how the Bank was achieving the objectives stated in this year's Annual Report and that further progress had not been made in setting measurable targets. The Act talked of making the most effective use of the Bank's resources and she wondered what was being done in measuring efficiency gains.

Mr Neill welcomed Mr Clementi's comments and particularly the prospect of new measures of performance. He recommended that the Bank should adopt the Investors In People programme and was supported by Sir Colin Southgate and Sir David Lees. However Ms McKechnie was concerned that IIP was a process and was not focused on measures of outcome. She supported Dame Sheila Masters' call to tease out more performance measures.

Mr Morris noted that the Bank's power over interest rates meant that it had become very relevant in ordinary people's lives, but whereas the Bank was good at explaining itself to the City it was not very good a talking to the wider nation.

Mr Bailie thought that the Printing Works target to cut its costs by 1% was not ambitious and wondered if this was a sufficient pay back on investment.

Summing up, the Governor noted that this paper reflected the budget discussion of last November and was raised with Court at this time in order to bring out this discussion of performance measurement. He hoped Court Members would approach Mr Clementi with their specific suggestions on performance measurement. Mr Clementi said he found the discussion useful and was hopeful that further objective tests could be found on the Bank's performance. He noted that the property strategy had been discussed in May and that the Bank was now heavily engaged in an exercise to regroup into one building. He promised to return to Court on the issues raised in November.

Quarterly Financial Report (Mr Midgley in attendance)

In introducing the financial report for the quarter ended 31 May 1998 which had been produced under the new format, Mr Midgley pointed out that income was higher than budgeted as the new regime of reduced CRDs had not been introduced until 1 June and this was only partly offset by a delay in receiving the accommodation charge from the FSA and a reduction in tariff income following a review of RTGS charges. He pointed out that the expenditure figures did not fully take into account phasing throughout the year and that there had been some reclassification of expenditure between capital and current expenditure reflecting how departments were tackling millennium compliance.

Sir David Lees said that the accounts were a big improvement on what had gone before, but raised two points on presentation.

Mr Buxton noted the forecast of retained profit and wondered if there should have been an analysis of the extent of retained profits and capital for balance sheet purposes. The Governor said that this question had been looked at in the context of establishing the new CRD regime and promised to circulate relevant papers to Court Members.

Committees of Court and Pension Funds - Revisions to Membership and Trustees

There being no changes to the membership of the Remuneration Committee and the Trustees of the Court Pension Scheme, the Governor drew Members' attention to proposals for changes to membership of the Audit Committee and Trustees of the Pension Fund, as set out in a document in folders.

Court APPROVED the revised memberships, namely:-

Audit Committee	**Trustees, Staff Pension Fund**
Sir David Lees, Chairman	Mrs Heaton, Chairman
Sir Neville Simms	Mr Clark
Mr Neill	Ms Lowther
Mr Buxton	Mr Stretton
Mr Hawker	Mr Bixby
	Mr Piper
	Mr Ross

Revision of the Terms of Reference of the Audit and Remuneration Committees

The Governor noted that in recognition of the means by which NEDCO proposed to discharge its new responsibilities it had been necessary to make some minor amendments to the Terms of Reference of both the Audit and Remuneration Committees and copies of these revised documents had been circulated to Members in advance of the meeting.

Sir David Lees, as Chairman of the Audit Committee; proposed the revised Terms of Reference and said that they had been redrafted to make them more orderly and readable as well as reflecting the creation of NEDCO. He thought Court should review the Terms of Reference at least triennially.

Sir David Cooksey proposed an amendment to the Constitution of the Committee to include a reference to "the Auditor". The first sentence would therefore read: "The Audit Committee is established as a Committee of Court in meeting its responsibilities in respect of financial reporting and to provide a direct channel of communication between the Auditor, the external auditors and the Court".

Sir Colin Southgate, as Chairman of the Remuneration Committee, proposed the revised Terms of Reference.

Court APPROVED the revised Terms of Reference of the Audit Committee (subject to the amendment noted above) and the Remuneration Committee.

Report on the June meeting of NEDCO (Mr Berkowitz in attendance)

Dame Sheila Masters introduced her paper which outlined the means by which NEDCO proposed to operate and discharge its functions under the Bank of England Act 1998. She noted that the minutes of the June meeting of NEDCO had been circulated which described how NEDCO would carry out its responsibilities through Court and would then consider whether the Court discussion had been sufficient.

Dame Sheila Masters invited Court to:-

(i) approve the way NEDCO proposed that Court and NEDCO should discharge their respective statutory responsibilities under Sections 2, 3 and 16 of the Bank of England Act 1998;

(ii) note that NEDCO would want to confirm that the revised terms of the Remuneration and Audit Committees met NEDCO's statutory responsibilities; and

(iii) note that a paper on MPC procedures would be considered by Court in October 1998.

Court APPROVED and NOTED the above points.

The Governors' Engagements

The Governor reminded Members that he looked forward to seeing them at the Informal Court Dinner that evening.

Sheila Masters
Chair [illegible]
19 August 1998

A COURT OF DIRECTORS AT THE BANK

WEDNESDAY 19 AUGUST 1998

Present:

Dame Sheila Masters, Chairman, Sub-Committee of Directors
Mr Clementi, Deputy Governor - Financial Stability
Mr King, Deputy Governor - Monetary Stability
Mr Allsopp
Mr Buxton
Sir David Cooksey
Mr Hawker
Mrs Heaton
Ms McKechnie
Sir Neville Simms
Mr Stretton

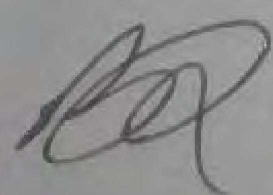
In the absence of the Governor and in accordance with Schedule 1, Section 13(3) of the Bank of England Act 1998, Dame Sheila Masters took the Chair at Court.

The Minutes of the Court of 15 July 1998, having been circulated, were approved.

MONETARY STABILITY ISSUES

The Inflation Report, together with the economic and monetary discussion, incorporating the monthly MPC Report to Court (Professor Goodhart and Mr Barker in attendance)

In introducing the monthly MPC report, Mr King said that the Bank's legal adviser had recommended that Court should explicitly note that the monthly MPC report was made pursuant to Schedule 3, Section 14 of the Bank of England Act 1998. In future this would be made clear in the Agenda notice for the meeting. In response to Mrs Heaton, Dame Sheila Masters reminded Court that a paper on MPC procedures would be discussed at the October Court meeting.



Turning to the Inflation Report, which had been published the week before, Mr King said the UK was now moving into a difficult stage of the economic cycle. Growth was slowing to below trend, and yet inflation was still influenced more by earlier above trend growth and resulting pressures on capacity than by the easing of those capacity pressures which would in due course result from a slowing of the pace of activity. After the deep recession of the early 1990s, it had been possible to grow above trend with falling inflation. That reflected the depth of recession and it had come to an end.

The economic slowdown foreshadowed in the May Inflation Report was now clearly evident. Although the first estimate of GDP growth in the second quarter was, if anything, a little higher than expected in May, the growth rate of non-oil output fell from 0.6% in the first quarter to 0.4% in the second. And, more recently, business surveys confirmed a sharp downturn in business optimism in manufacturing. Slower growth was also now apparent in services. For over a year, the MPC had pointed to the need for a fall in domestic demand growth. That too was happening. Final domestic demand was growing at around 4% in the second half of last year. That was likely to have fallen to around 3% in the first half of this year.

The MPC expected output growth to fall below trend over the next year or so before picking up at the end of the forecast horizon, as net trade no longer continued to deteriorate and domestic demand growth started to pick up. The central projection for output growth was somewhat lower than in May reflecting in large part a more depressed picture for private investment.

In May, the MPC thought that inflation was likely to rise to about 3% as measured by RPIX. That reflected the fact that the Budget changes to excise duties took effect earlier this year than last. In the event, RPIX inflation peaked at 3.2% in May and had fallen back to 2.6% in July. The latest projection was for inflation to rise somewhat over the next year before falling back to the target level of 2.5% two years ahead. At the two year horizon, there was little change in the projection between May and August. But the profile was rather different. The news on earnings growth since May - including not only higher figures in recent months but also revisions to earnings in earlier months - had led the MPC to conclude that there was more compelling evidence that unemployment was below the natural rate than existed before. Hence earnings growth was expected to continue to rise for a time reflecting the tight labour market

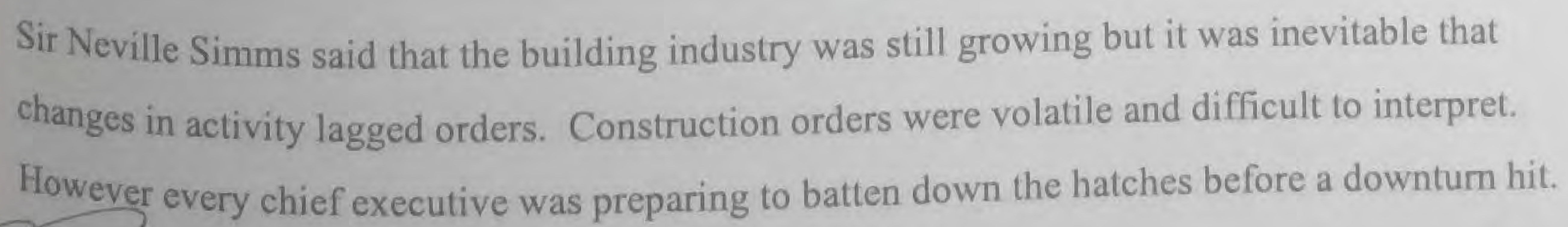
before falling back as below trend output growth led to some rise in unemployment and a fall in earnings growth.

The labour market data published last week were a surprise. The fall in unemployment was larger than expected. And the fall in earnings growth was as encouraging as it was surprising. Earnings growth in the economy as a whole fell from 5.4% last month to 5.0% this. These figures would require careful analysis. Even taken at face value, earnings growth remained above the levels in May and, in the private sector, were 1% point higher than a year ago. So the tightness of the labour market, discussed in the Inflation Report, was still having an influence.

The August projection included for the first time the MPC estimate of the impact of the National Minimum Wage. That was thought likely to add about half a percentage point to the level of earnings, a little less to the price level, and to have a small but temporary impact on the measured inflation rate over the next year.

The objective of the MPC was clear. As its remit stated, its aim was to achieve an inflation target of 2 1/2%, but the remit recognised that unexpected developments could, on occasion, cause inflation to deviate from its target. In those circumstances attempts to keep inflation at the target might cause undesirable volatility in output. The MPC believed that although there might be a temporary rise in inflation over the next year, looking ahead to the forecast horizon the inflation target would be met. But, as the Report concluded, when and where interest rates moved would depend on how far and how long inflation was likely to remain above target.

Mr Buxton agreed that it was difficult to analyse the economy at this point of the business cycle. Although there was plenty of evidence of an economic slowdown, other areas, such as IT, were booming. Viewed from Barclays Bank he saw more small businesses reporting problems but in general the corporate sector remained very liquid.



Sir Neville Simms said that the building industry was still growing but it was inevitable that changes in activity lagged orders. Construction orders were volatile and difficult to interpret. However every chief executive was preparing to batten down the hatches before a downturn hit.

Mr Allsopp said that the Inflation Report gave a fair and balanced picture of the slowdown. Pressures on the Monetary Policy Committee would intensify as the economy slowed further. In presentational terms it was important to explain what actions the MPC was taking and how these would affect different sectors.

Mr King noted that once earnings growth picked up it was often difficult to slow it down again and therefore the MPC had to take prompt action. There was uncertainty over why bonuses had grown so fast as the ONS did not have good data. Profit levels in 1997 were little changed from a year earlier and so it was not correct to see increased bonuses simply as a response to profit rises. Although the Bank smoothed bonus payments over the year, there was no unique way of doing that. There had been some press discussion of our methods sparked by an article by Professor Marris but in fact his data could be reconciled with the Bank's own work and showed broadly the same picture. Mr King felt there was a need to see an easing in labour market pressures before overall earnings data could improve. He explained that the ONS data on bonuses was derived from only those 20% of companies surveyed. Ideally data should be obtained from all employers and the Bank would press ONS for better coverage, although he noted that the ONS faced resource constraints.

Mr Buxton thought that the bonus culture was more prevalent in the services than the manufacturing sector and wondered if the greater profitability of the service sector might be a factor.

Sir Neville Simms said that it was difficult for employers to reduce annual increases in earnings without an external shock to justify it, so he understood how earnings growth could lag the business cycle. On earnings growth, he noted that there had been a move towards performance-related bonuses and these were often tied to non-financial factors. He thought that recently the MPC had come out better in the press and there was a growing recognition that they were simply doing their job in meeting the Government's inflation target.

Sir David Cooksey noted that the replacement of share option schemes by long term incentive plans for the remuneration of senior executives is distorting bonus payments. Such schemes require the purchase of shares by the employer, which would be charged to the pay bill but not actually awarded to executives until three years later. Options, as previously awarded, had no

cost in pay bill terms. He believed that consumer confidence had fallen markedly and people were becoming afraid to spend as they read more newspaper stories of recession. He noted that many of his clients were replacing all of their IT systems ahead of the millennium but this huge increase in demand for IT skills would disappear at the end of next year. Mr Hawker agreed, noting that IT spending by utilities was very high but thought that spending on EMU preparations would pick up after the millennium.

Mr Stretton said that the financial sector had lost part of its skill base in the last recession and there was now a need to give higher earnings in order to retain skilled staff.

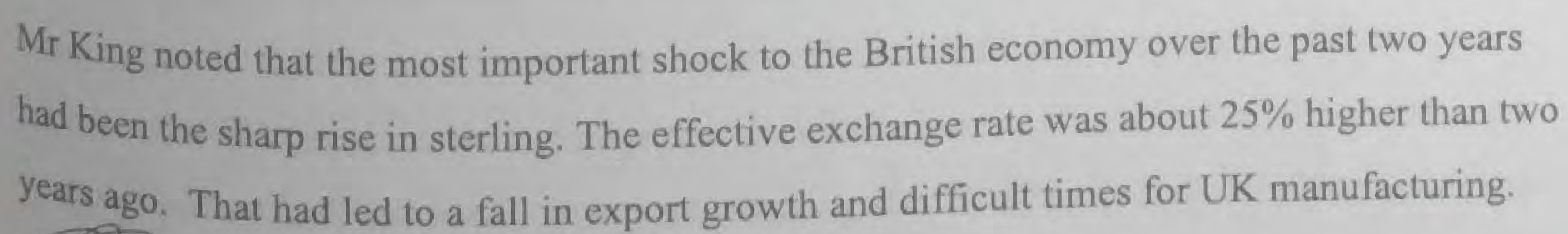
Ms McKechnie raised the role of Court in respect of the inadequacy of the earnings data that Mr King had referred to. Dame Sheila Masters reminded Court that its role included ensuring that the MPC had sufficient resources. Mr King welcomed Court's support in this matter but said that first the Bank would raise its concerns with the ONS, the Treasury and the Treasury Select Committee. The subject could be considered again in October's discussion of MPC procedures. Professor Goodhart noted that, even if the data could now be improved, it could be years before there was a sufficient history to permit improved forecasting of earnings.

Mr Stretton noted the difficulty of measuring productivity in the services sector and thought it might have been under-stated. Professor Goodhart said that if this was so then output in the services sector would have been higher, with implications for the size of the output gap and the prospects for inflation.

Dame Sheila Masters drew the discussion to a close by noting Court's feeling that it knew too little about earnings growth and that this would be looked at again in the discussion of MPC procedures.

Domestically Generated Inflation (Professor Goodhart and Mr Barker in attendance)

Mr King noted that the most important shock to the British economy over the past two years had been the sharp rise in sterling. The effective exchange rate was about 25% higher than two years ago. That had led to a fall in export growth and difficult times for UK manufacturing.



But it had also altered the inflation picture. Import prices had fallen in sterling terms, and that had helped to keep inflation close to the target when it would otherwise have been well above target. Since sterling was no longer rising, the one-off impact of lower import prices on the domestic price level was coming to an end. When that wore off, retail price inflation would return to the rate of inflation generated by pressures in the domestic economy. This rather loose concept was called "domestically generated inflation".

Because of the lags between changes in interest rates and their impact on inflation, it was necessary to look ahead when setting monetary policy. That meant that the MPC had to look beyond the time when the rise in sterling had had its initial effect on domestic inflation, and to the upward pressures on prices in both product and labour markets. Looking two years or so ahead, domestically generated inflation was the major influence on retail price inflation.

The paper set out three different ways of trying to measure domestically generated inflation. The first started with the broad measure of inflation in the UK economy - the GDP deflator - and took out the contribution of export price inflation. That had been held down as UK exporters cut sterling prices in order to retain market share. Adjusting the GDP deflator in this way, the first measure of domestically generated inflation showed a rise in the year to 1998 Q1 of 3.4%.

The second measure started with retail price inflation and deducted the impact of lower import prices. This showed a higher estimate of domestically generated inflation of over 4%. This was likely to overestimate underlying inflation because falling import prices had boosted retailers' profit margins. These were likely to fall back.

The final measure of domestically generated inflation was based on unit labour costs. These grew by 3.0% in the year to 1998 Q1.

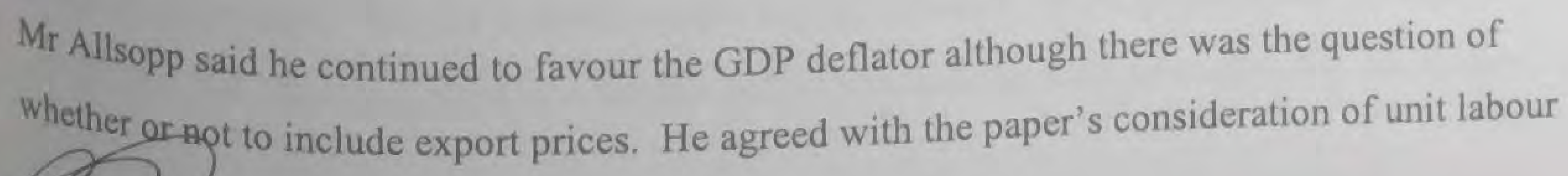
The main conclusion of the note was that retail price inflation was still being restrained by the appreciation of sterling over the past two years. Those effects will wear off, and the contribution of domestic inflationary pressures would come more to the fore. There was no precise measure of domestically generated inflation, and all of the measures had to be treated with care.

Mr Allsopp said that the paper was helpful. His reason for raising the subject was that the Chancellor had given the Bank an inflation target in terms of RPIX but economists were concerned with the control of underlying inflation and so the question was how you measured the latter. Different measures of inflation were currently giving different readings. In particular the European Harmonised Index and the GDP deflator were both giving significantly lower readings than RPIX. The key component of any measure of domestically generated inflation would be earnings and it certainly seemed that the current growth of earnings was not consistent with the 2 1/2% RPIX target. One could argue that the GDP deflator was the best guide to underlying inflation but he questioned why the paper advocated excluding export prices as surely they were a relevant factor in business conditions. In response, Mr Barker said that the profit element in the GDP deflator could be affected by the strength of sterling and as a consequence the GDP deflator might increase as the exchange rate fell.

Mr King explained that the European Harmonised Index was calculated on a different basis than RPIX and usually gave a lower figure. If it were adopted as a target nothing would have changed in reality so the target level would have to be set at lower than 2 1/2%. Dame Sheila Masters asked if the Bank considered RPIX a good target and Mr King answered that the Bank saw a lot of merit in RPIY, as it excluded Budget effects but there could be disadvantages in terms of confidence if the target were changed.

Sir David Cooksey said that the public focused on headline RPI and this affected pay negotiations. Could the Bank shift the public's attention towards RPIX? Mr King noted that only the UK and Ireland included mortgage rates in their main inflation measure. The ONS used an impartial body of experts to consider the precise measures of inflation and they had felt it right to continue to incorporate mortgage costs in the figure. As the RPI was linked to a wide range of benefits it was difficult for the Government to alter the measure for monetary policy reasons. Ultimately the answer might be for the Government to adopt the European Harmonised Index once its definition had been finally resolved by European countries.

Mr Allsopp said he continued to favour the GDP deflator although there was the question of whether or not to include export prices. He agreed with the paper's consideration of unit labour



costs as a measure of domestically generated inflation and noted that their recent rise was a crucial factor in monetary policy decisions.

The International Economy (Professor Goodhart, Mr Clark, in attendance)

In introducing the paper entitled "Japanese Policy Options", Mr King said that the consequences of the Asian crisis for world trade and output bore a striking similarity with the first oil price shock in 1973-74. The growth of world trade halved between 1973 and 1974. The latest IMF forecast predicted that the growth of world trade was also likely to halve in 1998. The IMF currently expected the growth of world trade to pick up in 1999, but there was a real danger that things might turn out far worse in the event of a chain of competitive devaluation and debt default. There were too many countries in which things could go badly wrong.

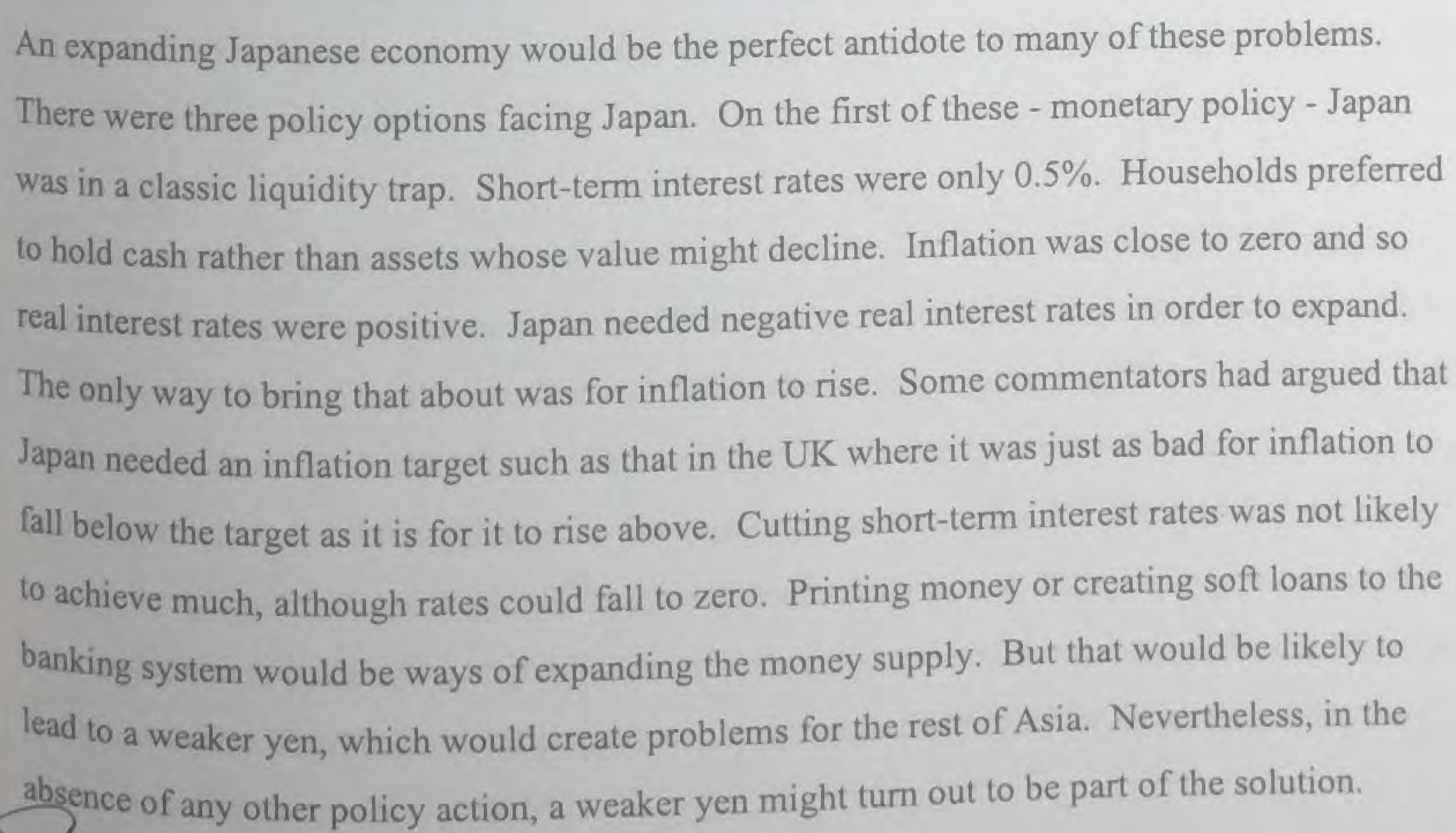
Although the US economy continued to show remarkable resilience with continuing output growth and low inflation, the Japanese economy continued to face problems. In the fifteen years prior to 1970 the average growth rate of the Japanese economy was almost 10%. Over the past five years its growth had been close to zero. Economic policy had been incompetent, and over the past year China had skilfully exploited the lack of leadership which Japan had offered to the rest of Asia. The clean-up of the Japanese financial sector would take a long time. And there had been a further decline in both business and consumer confidence in the past six months.

The economic situation had stabilised somewhat in Thailand and Korea, but problems remained in Indonesia and Malaysia. Nor was it easy to be optimistic about Russia. The fundamental problems were extremely serious - an unsavoury combination of politics, business and crime meant that there were serious structural problems in the economy, including an inability to collect tax revenues which had put a strain on the public finances and led to an inability to pay public sector wages. The risk was of a return to high inflation as the government tried to recapitalise the banking system and finance public expenditure with an inadequate tax system.

Latin America might be affected by contagion. Most countries there have large current account deficits and had seen significant real appreciations of their currencies during the 1990s. In several countries, including Brazil, the public finances were not in good shape and it might not take much for foreign investors to lose confidence. Elsewhere, South Africa was a cause for concern with growth inadequate to prevent rising unemployment.

There was more ground for optimism about the position of China. It was by no means obvious that China would wish to devalue. 50% of its exports comprised imported goods, and it already had a bilateral trade surplus with the United States of $50 billion a year. A devaluation in China would make it very difficult for Hong Kong to maintain its currency board link with the US dollar and that would be a bad signal for China to give so soon after taking over responsibility for Hong Kong.

All in all, it was likely that more and more commentators would make comparisons with the Great Depression. One of the world's two largest economies was in recession, and there had been a sharp fall in world commodity prices. There had not yet been a sharp fall in stock markets in the industrial countries, but they had shown a correction of around 10% over the past month. The immediate question was whether developments in Russia and Asia would lead to a contagious round of pressures on other currencies leading to further debt defaults.



An expanding Japanese economy would be the perfect antidote to many of these problems. There were three policy options facing Japan. On the first of these - monetary policy - Japan was in a classic liquidity trap. Short-term interest rates were only 0.5%. Households preferred to hold cash rather than assets whose value might decline. Inflation was close to zero and so real interest rates were positive. Japan needed negative real interest rates in order to expand. The only way to bring that about was for inflation to rise. Some commentators had argued that Japan needed an inflation target such as that in the UK where it was just as bad for inflation to fall below the target as it is for it to rise above. Cutting short-term interest rates was not likely to achieve much, although rates could fall to zero. Printing money or creating soft loans to the banking system would be ways of expanding the money supply. But that would be likely to lead to a weaker yen, which would create problems for the rest of Asia. Nevertheless, in the absence of any other policy action, a weaker yen might turn out to be part of the solution.

Fiscal policy was, on the face of it, a more promising avenue. So far, the Japanese authorities had been willing to make only temporary tax reductions leaving in place the path of fiscal consolidation introduced earlier. More "permanent" tax cuts had been promised, but it was possible that it was too late for these to work, since households might well anticipate that there might be higher taxes in the future. But a more aggressive fiscal policy in the short run might raise the level of output, and hence tax revenue, thus enabling fiscal sustainability in the long run to be combined with expansion in the short run.

On financial sector restructuring there was an urgent need for recapitalisation of the banking system. The scale of bad loans was horrendous. And it extended to other parts of the financial system such as insurance companies. The problem had been allowed to drag on for so long that even the package of yen 30 trillion might now be insufficient to deal with the scale of the losses. The authorities had introduced a "bridge bank" mechanism to allow weak or failing banks to be restructured and sold back to the private sector, following the examples of similar mechanisms in the US and Scandinavia.

In all of these areas drastic and urgent action was required. None had yet been forthcoming.

In those cases where financial crisis had led to economic collapse, the cause had often been the absence of a political system capable of implementing the right decisions. That was true of Japan, and, unfortunately, also of a number of other countries. With global capital markets, the price of inaction was high.

Turning to recent events in Russia, Mr Clark said that the debt restructuring announcement which had been expected that morning had been postponed to the forthcoming Monday, which raised the risk of more market confusion. G10 banks had an exposure of $70mn to Russia, half of which was held by German banks, although part of this was guaranteed by the German Government as it was lending linked to German reunification. The US and French banks had exposures of $6-7bn whereas UK banks exposure was only around $1bn. However, these data did not include recent trading exposures or off-balance sheet exposures such as forward foreign exchange deals. Therefore the Russian moves were not catastrophic for international banking unless they triggered wider defaults.

Mr Allsopp welcomed the paper on Japan which he found refreshingly honest compared with other official analyses. However, there was one upside factor in that the Japanese private sector was rapidly accumulating foreign assets which could eventually encourage an increase in spending.

Ms Hammond reported that in Eastern Europe only Ukraine and Lithuania were major trading partners with Russia. Of western countries, Germany was the largest partner but Russia still accounted for only 2% of German exports. In Britain's case the figure was only 0.6% of exports.

Mr King said that the main contagion concern over Russia was the fact that it had defaulted in the middle of applying an IMF programme and as a consequence of an inability to obtain further G7 funding. In answer to Sir Neville Simms, Mr King said that the MPC's analysis of the UK economy took into account our expectations of continued weak Japanese economic performance, but did not take into account the consequences of a chain of debt defaults as the probability was small and the MPC would react to that eventuality, if and when it occurred.

Turning to Japan, Mr Buxton said that the fundamental problem was a lack of consumer confidence with the Japanese public sceptical about the effectiveness of fiscal measures. He was concerned that Japanese bankers did not seem to appreciate the scale of measures which were necessary.

Mr Clementi noted that the Japanese "bridge bank" was aimed principally at the problem regional banks but the need now was to deal with the large money centre banks. He advocated a restructuring to reduce those banks from 18 to just five or six. The Bank of Japan accepted that analysis but there were cultural problems in rationalising Japanese institutions. Another complication was the fact that the authority of the Ministry of Finance and the Bank of Japan had been undermined by recent scandals. The banking situation was held together by the Japanese government's guarantee of their major banks but insurance companies were emerging as another major weakness.

Ms McKechnie said that the Japanese situation was more acute than anything she had read in the press and wondered if our analysis was shared by other G7 countries. Mr King said that it was.

Sir David Cooksey asked how confident the Bank felt that Japanese banks in London were ring-fenced. Mr Clark responded that we relied on Ministry of Finance and Bank of Japan assurances. Mr Buxton said that a reassuring factor was that the Japanese Government had very large resources with which to support its banks but Mr Allsopp pointed to the unpopularity of banks in Japan and the political difficulty of providing financial support.

Considering the implication for the UK, Mr King said that the prospects of weak commodity prices would continue but there could be a weaker outlook for UK trade. The European Central Bank could face a dilemma as the policy needs of its individual states might vary accordingly to their different exposures to a deteriorating international environment. Mr Allsopp said that a continued deterioration in Asia, with exchange rates weakening further could cause the US to have an unsustainably large trade deficit and this in turn could affect the demand for UK goods.

In reply to Sir David Cooksey, Mr King said that the IMF's financial and staff resources were already stretched by the various international financial crises and the fact of a default during the course of an IMF programme could undermine confidence in IMF measures.

Dame Sheila Masters noted that Court would probably come back to this issue repeatedly over the next few months.

FINANCIAL STABILITY ISSUES

Financial Stability - Current Issues (Mr Clark in attendance)

Mr Clark reported on developments in LIFFE. Brian Williamson had been appointed Chairman. The Bank had kept close to the discussions leading up to the appointments but had not had the decisive role suggested in the press. It now seemed widely accepted that floor trading was not the future and LIFFE was currently putting a great deal of effort into

developing a screen trading system. Williamson was focussing on a streamlined, cheap and efficient system for wholesale derivatives trading. LIFFE were actively looking for a new Chief Executive. The Bank was keeping in close touch with LIFFE on all of these issues.

Mr Clark also reported that the Securities Settlement Review was proceeding well and he hoped to make proposals in the first half of September on a merged CREST, CGO and CMO. If this were achieved, the Bank would no longer be operating securities settlements systems but would, of course, be concerned to see that such systems were robust and efficient.

Sir David Cooksey said that the EU Commission had been concerned about the number of Stock Exchanges in the European Union. Mr Clark responded that market participants did not want to finance duplicate exchanges; the drawing together of the London and Frankfurt Stock Exchanges should be seen in that context.

MANAGEMENT OF THE BANK

Recommendations from the Remuneration Committee

In the absence of Sir Colin Southgate, the Chairman of the Remuneration Committee, Dame Sheila Masters turned to proposals put forward by the Committee. She said that the Bank had been looking to standardise the pension arrangements for those MPC members appointed by the Chancellor and for Advisers to the Governor. The following recommendations were laid before Court:

The Committee recommended that:

For those under 60 years of age: the option of either pensionable service as a member of the Staff Pension Scheme, or non-pensionable service plus a supplement of 15% of salary.

For those over 60 years of age: those over 60 joining the Bank for the first time, non-pensionable service plus a supplement of 15% of salary. For those over 60 who had previously undertaken pensionable service as a member of either the Bank Staff or Court

schemes, the amount of their pension to be increased by a late retirement factor plus RPI until brought into payment. This last provision meant that pensions would be taken at the age of 60, but payment would be deferred; as a result of leaving pensions in the Bank Staff Fund after retirement age, the amount to be paid on eventual retirement would increase annually at the investment rate - currently 6% plus inflation pa. For those over 60 who had previously undertaken non-pensionable service at the Bank, further non-pensionable service plus a supplement of 15% salary.

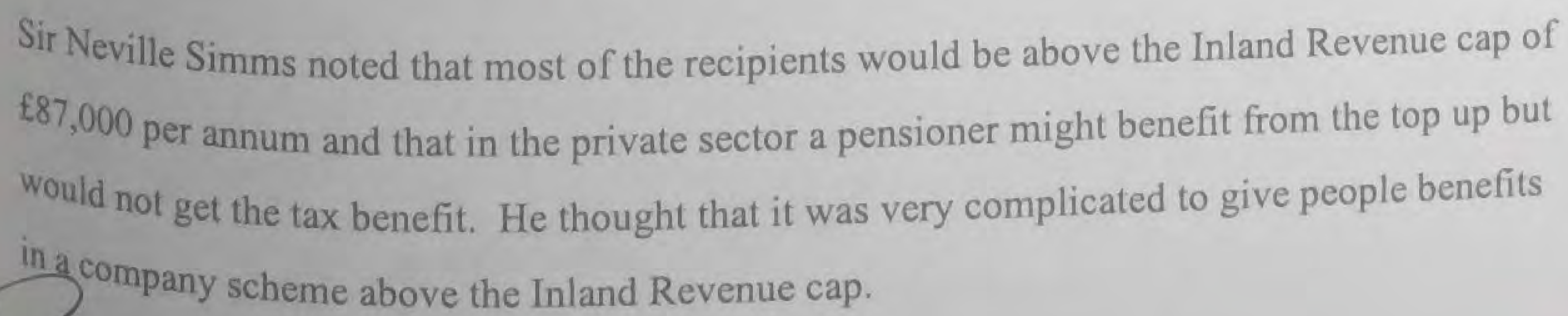
In all cases, individuals would receive death-in-service benefits.

All existing staff in this group would be reviewed following the introduction of the new arrangements, and the principle of grandfathering would be applied to the extent that no one would be worse off in terms of the benefit they received.

Mr Buxton pointed to the case of officials aged over 60 who already had Bank pensionable service. He considered that the proposal that their deferred pension should increase annually at the investment rate plus inflation was too generous as the investment return should itself include an allowance for inflation. Mr Stretton acknowledged that this was generous but pointed out that it conformed with the way the Staff Pension Fund was operated and in any case it only applied to the deferred part of the pension. Dame Sheila Masters suggested that the scope of the Staff Pension Fund could be regarded as a separate issue which Court could look at on another occasion.

Mr Stretton noted the 15% supplement to salary in the case where there was no pension entitlement and felt that this was less than the cost to the scheme of a pension right. Dame Sheila Masters said that this figure had been a pragmatic choice in the light of the Scheme's actual costs and in the light of the individuals involved.

Sir Neville Simms noted that most of the recipients would be above the Inland Revenue cap of £87,000 per annum and that in the private sector a pensioner might benefit from the top up but would not get the tax benefit. He thought that it was very complicated to give people benefits in a company scheme above the Inland Revenue cap.



Dame Sheila Masters agreed that Court should return to these policy issues in September. In the meantime perhaps the Remuneration Committee might need to make a specific recommendation in the case of one individual.

Staff Benefits

Ms McKechnie asked what progress had been made in defining market-related pay for Bank staff. Mr Clementi reported that consultants had been appointed to look at the possibility of introducing a flexible benefits package for staff and he hoped to bring their recommendations to Court before February.

Executive Report: Non-Executive Directors' Remuneration

Turning to the question of Non-Executive Directors' remuneration, Mr Clementi reminded Court that the Governor had written to the Chancellor on 21 May making a proposal but had not yet received a reply. There would therefore be no remuneration for the period from 1 June until such time as agreement was reached, but the eventually-agreed package would be backdated.

Sealing Committee Minutes/Authorities for inspection

In accordance with the terms of reference of the Sealing Committee, the Minute Book and Authorities record of that Committee were laid before Court for inspection.

Dame Sheila Masters thanked Court and the meeting ended.

Sheila Masters

Peter Rodgers

16 September 1998

A COURT OF DIRECTORS AT THE BANK

WEDNESDAY 16 SEPTEMBER 1998

Present:

Mr George, Governor

Mr Clementi, Deputy Governor - Financial Stability

Dame Sheila Masters, Chairman, Sub-Committee of Directors

Mr Allsopp

Mr Bailie

Mr Buxton

Sir David Cooksey

Mr Davies

Mr Hawker

Mrs Heaton

Sir Chips Keswick

Ms McKechnie

Mr Neill

Sir Colin Southgate

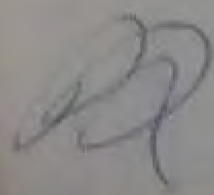
Mr Stretton

The Minutes of the Court of 19 August, having been circulated, were approved.

MONETARY STABILITY ISSUES

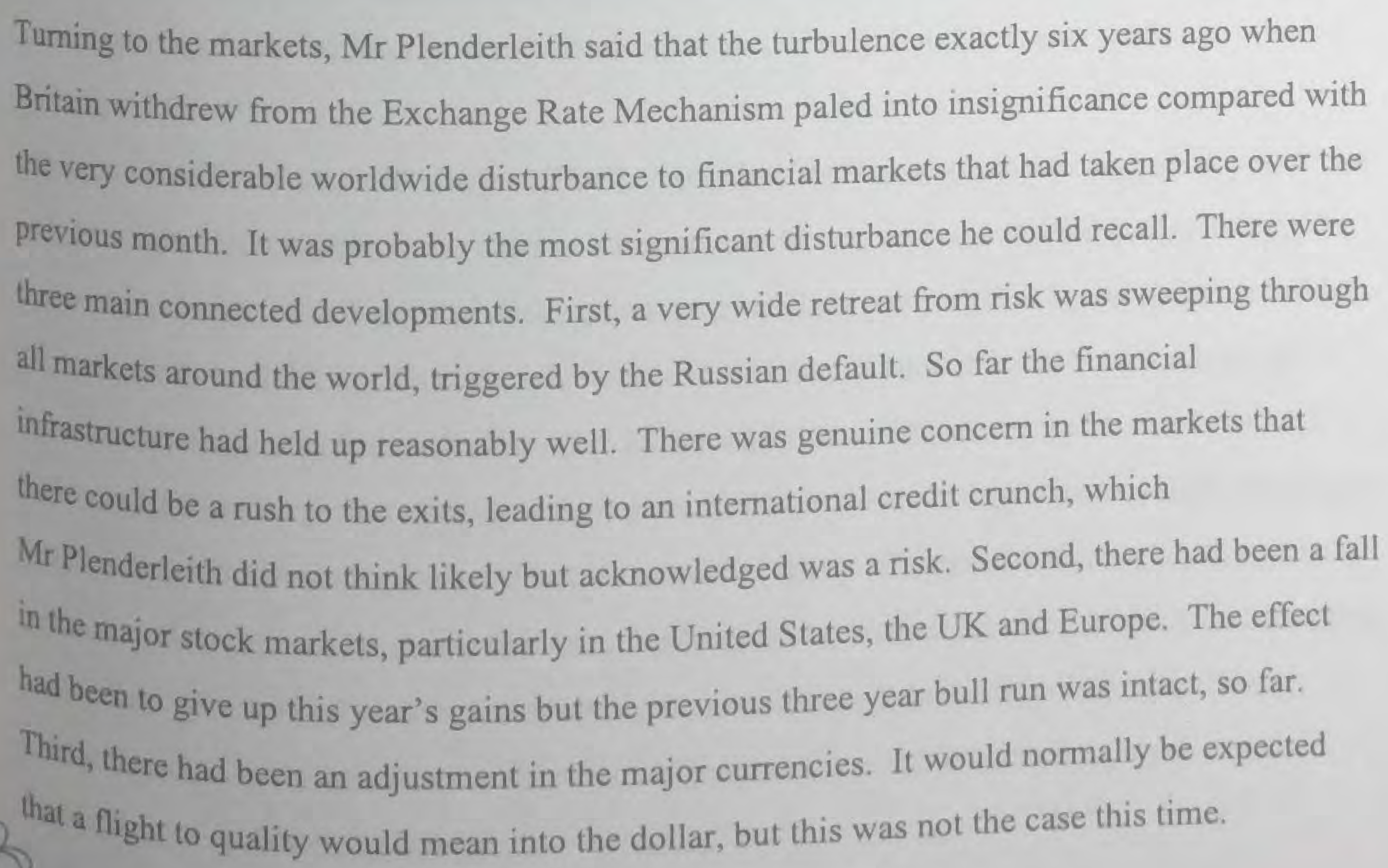
Economic and Monetary discussion, incorporating the monthly MPC Report to Court (Messrs Vickers and Plenderleith together with Dr Julius and Professor Buiter in attendance)

Mr Vickers noted that the minutes of the MPC meeting held in August had been published during the morning of the Court meeting. The August Inflation Report, which had been discussed at the last Court, had set out the economic issues faced by the Monetary Policy Committee at the time. Mr Vickers said that at the September meeting of the MPC there had again been no change in interest rates, but a statement had been issued, the first time this had



been done when rates had not changed. Since Court had last met, international developments and financial market movements had overshadowed domestic news. Turning first to the recent UK data, Mr Vickers noted a number of puzzles and questions including the interpretation of the build-up in stocks, a sharp fall in construction output after a strong first quarter, some curious balances in the CBI distributive trades and strong credit growth, largely due to secured lending, despite an apparent deterioration in sentiment and reports of an easing in the housing market.

Mr Vickers noted that RPIX and RPI inflation had fallen back slightly in August as the remains of the July 1997 petrol excise duty rise fell out of the annual inflation rate. RPIX rate was on target for the second time this year and would have been below 2.5% were it not for a large rise in seasonal food prices. RPIY had been strikingly stable for 18 months. Mr Vickers noted the labour market data published on the morning of the Court meeting: these showed a continued improvement in quantities, with an easing in the earnings data. Further puzzles were a fall in workforce job numbers, and a fall in earnings figures when settlements data showed upward pressure. Finally, Mr Vickers noted that history was about to be re-written because the Office of National Statistics was re-basing and moving to the European system of accounts. He said he had promised a note for Court on the earnings data but it was probably more sensible to do that in November on the basis of the new information forthcoming from the ONS.



Turning to the markets, Mr Plenderleith said that the turbulence exactly six years ago when Britain withdrew from the Exchange Rate Mechanism paled into insignificance compared with the very considerable worldwide disturbance to financial markets that had taken place over the previous month. It was probably the most significant disturbance he could recall. There were three main connected developments. First, a very wide retreat from risk was sweeping through all markets around the world, triggered by the Russian default. So far the financial infrastructure had held up reasonably well. There was genuine concern in the markets that there could be a rush to the exits, leading to an international credit crunch, which Mr Plenderleith did not think likely but acknowledged was a risk. Second, there had been a fall in the major stock markets, particularly in the United States, the UK and Europe. The effect had been to give up this year's gains but the previous three year bull run was intact, so far. Third, there had been an adjustment in the major currencies. It would normally be expected that a flight to quality would mean into the dollar, but this was not the case this time.

The Governor noted that the major development had been a clear deterioration in the world economic situation, bringing greater risks than foreseen a month or six weeks ago. He asked Court Members for their comments, particularly on the domestic economy.

Sir Chips Keswick noted, as a director of a large house-building company, that the market was not steaming ahead, but neither was it weakening. Mr Neill noted that the car market, in the first ten days of September, grew 4% on the retail side and showed a 1.4% decline overall. The comparison with August 1997, when there had been windfall gains and also a change in the registration plate, could explain the slightly lower that usual August in part, but there were also supply problems for some more desirable cars. The figures were still giving confused signals about what was happening but the overall view was still that the second half would be lower than the first half. Some car manufacturers were having a very tough time but fundamentally this was because they were producing out-dated models or had poor productivity. Turning to stocks, Mr Neill said that production for the domestic market was about 50,000 cars ahead of consumption. Car manufacturers were denying that they were planning to take cars out of production, but Mr Neill did not believe them and he said that there could be some alarming headlines later in the year, leading to job losses. So far only Rover had taken cars out of production. Commenting on the used car market, Mr Neill said the volume was three times that of new cars. An understanding of the dynamics of that market might provide insights into what was happening in the economy, and he recommended it as a fruitful area of study.

Mr Buxton said consumer lending was still rising fast but was expected to drop next year. The rise in secured lending had to be seen in comparative terms, and was not particularly fast. On the corporate side, cash flow was under pressure as trading profits came under pressure, which led to a rise in borrowing. The next phase would be when banks' corporate customers cut investment and re-adjusted cash flow. Mr Bailie said that a CBI survey in Northern Ireland showed that there were two problems facing companies: the exchange rate and skills shortages. He saw signs of only a slight slow down in manufacturing. Companies were not talking about increasing their prices. He noted the risk of talking the economy into recession by undermining confidence. The lack of business confidence had outstripped the reality of the situation. Mr Bailie noted speculation in the Republic of Ireland about a fall in interest rates, and the impact of that on Northern Ireland.

Mr Stretton noted that Welfare to Work and the New Deal, piloted in Scotland, made unemployment appear to go down, and he believed it would be worth understanding that issue in detail. Mrs Heaton, commenting on Mr Bailie's comments on confidence, wondered whether a reduction in interest rates would have much effect, because confidence was very much related to what people read and talked about. Sir Colin Southgate said that the retail market was flat in his industry and the music market was under great pressure because of the strong pound. However, information technology was still booming and shortage of staff was a problem. Recruiting was still strong at middle and senior levels in industry. His view was that the domestic economy was on the way down.

Mr Allsopp noted the weight attached to the earning figures, which were very uncertain, and advised that there was no alternative to being cautious about them. Sir David Cooksey said that he was involved with three mid-sized companies which had long term incentive plans which would add 1% to payrolls but the money would not be awarded to the individuals concerned for three years. This could be one of the distorting factors in bonus calculations. He also noted substantial stock building in the retail sector, mainly driven by decisions by Marks & Spencer, which had not been able to shift goods. This would have a brief distorting effect on prices.

Mr Hawker said that there would be step changes downwards in prices for the utilities but these would not take effect until the year 2000. They would be announced soon, and could however have an effect on behaviour in pay negotiations. He also recognised that the effects of new competition in electricity and gas would begin to be seen later this year.

Ms McKechnie noted suggestions that there could be a co-ordinated G7 response to the world economic situation through cuts in interest rates. She asked what were the implications of this for the role of the Monetary Policy Committee. The Governor commented that the Bank was not unique in this. The Bundesbank, the Fed and the Bank of France were independent. The Chancellor could not say that he and other politicians had agreed that the MPC should cut interest rates. It was possible for him to reduce the objective or suspend the target. In practice the Chancellor and his counterparts abroad were much more likely to engage central banks in a discussion, which was in fact now taking place. It would be for the MPC to consider the arguments in a global context against the objectives that had been set for it.

In reply to a question by Mr Bailie, the Governor said that the Bank would not specifically advise the Government that other instruments than monetary policy should be used, but it would make clear the implications of fiscal policy for monetary policy. Messages in this area were conveyed through the Treasury representative at MPC meetings, but were not reported in the minutes.

Dr Julius noted that the MPC had stated at the end of its last meeting that it had had extensive discussions of the international situation and that they were high on the Committee's agenda. That was a logical and perfectly consistent route through which the MPC would consider international developments. She had been struck by the care taken by various Treasury and Government representatives in their statements. They had been circumspect about an issue which affected central bank independence. Mr Vickers said he agreed with Dr Julius. The tension between what had been happening and the appropriate policy was not as great as Ms McKechnie's question may have suggested.

Replying to earlier comments by Directors Mr Vickers said, with reference to housing market activity, that he was referring more to second-hand houses than new houses. On the question of the second-hand car market, Mr Vickers said that the Bank was working on the market, whose prices were a significant component of the Retail Price Index. Enquiries would be pursued more vigorously still. On Northern Ireland, Mr Vickers said that Ireland's entry to the EMU zone could have interesting effects which would be followed through. Turning to the New Deal, he said the effects were being studied by the Bank but that they were not large enough to explain the workforce numbers. He also noted that the working families tax credit was an issue the Bank was pursuing, and it was talking to the Institute for Fiscal Studies to encourage them to do more work. Turning to information technology and the year 2000, Mr Vickers said it was hoped to cover the inflation effects in an Inflation Report (and perhaps in the QB). Commenting on the slowdown forecast by a number of surveys, he said the Bank had been projecting a slowdown for some time, and official data were very much in line with projections. The question was whether the surveys and stock building were showing something more alarming about the future. Commenting on labour market data he said that these were well short of perfect and the Bank was working as hard as it could with the ONS to resolve as many of the issues as it could. On the possibility that the MPC might have over-reacted to the

earnings figures, Mr Vickers said that the increase reported before the June meeting was from 4.5% to 4.9% and that policy had not reacted to subsequent numbers significantly above that.

The Governor commented that he did not get the impression that recession was hours away, judging by the comments of Court Members, but the Bank had to take the possibility seriously. Clearly there was a bigger risk in manufacturing.

Publication of MPC Minutes

Noting a decision by the MPC to change the timing of the publication of MPC minutes, the Governor said that there had been concerns raised about six months ago, prompted by an alleged leak of an MPC member's voting intentions. He had been very reluctant to respond to suggestions for a change in the timing of the release of the minutes on that pretext. But the Bank had in fact been concerned for a while about the awkwardness of defending a position that was six weeks old, which was a particular problem in relation to the Treasury Select Committee. So the MPC had looked carefully at this issue in the summer and concluded that it should advance publication of the minutes. A key question was whether there would be market disturbance if the minutes were published in advance of the next meeting. If MPC members wished to discuss assumptions related to decisions that might be taken at the next meeting, this discussion might also be inhibited. The MPC felt that such a situation was fairly unusual but even when it arose, it was not bad for the market to know that the MPC was giving particular attention to a particular facet of the analysis and, if this changed direction, the markets would then know how to react. So it had been decided that the delay in publication of the minutes would be shortened to about a fortnight.

The MPC had also considered the implications for explanatory press notices. The feeling was that if the MPC was going to publish minutes a fortnight after a meeting with a full and balanced account it might be possible to dispense with press notices after decisions. However all members were agreed that it was important to explain no change as well as change decisions, and although the MPC recognised that it might be appropriate in many, or possibly even most cases, not to put out a press notice, there were circumstances in which - rather than allow the market and the press to speculate - the Committee might nevertheless issue a notice. So in a covering letter to be sent to Giles Radice, Chairman of the TSC, the Bank said only that

it would not necessarily issue a press notice. The Governor noted that the US Federal Reserve was also considering advancing publication of its minutes.

FINANCIAL STABILITY ISSUES

International events - the implications for Monetary Stability and Financial Stability (Messrs Vickers, Plenderleith and Clark together with Dr Julius and Professor Buiter in attendance)

With reference to a Minute of 19 August focusing on international matters, Mr Vickers noted that there had been a rise in spreads, and an increasing appreciation of the risk of difficulties spreading to Latin America, together with gloomy news from Japan, where interest rates had been halved to one quarter of a per cent. He noted the Keynesian saying about the effectiveness of pushing on a string and also noted a number of channels by which the world situation could affect inflation prospects in the UK. Lower world demand affected net exports. Equity and wealth changes had an effect on the domestic economy. Domestic prices were directly affected by import prices, including commodity prices, which were weakening, and also by sterling. The impact of Russia, in isolation, was not large, since it was only 1% of world output and 0.7% of UK net exports, but it was part of a much wider picture, and there were therefore contagion risks. He also noted that forecasts of world growth were being reduced substantially to about 2% in 1998 and 2.5% in 1999.

Mr Clark commented that the rate at which Japan was tackling problems in the financial sector had not increased and if anything had slackened a little. This was partly because the process had become enmeshed in politics. The immediate question of Long Term Credit Bank reflected differences of view about how far equity holders should see any benefit from Government support. In Russia, he said the debate was very much more at the political level, and about the general direction of economic policy rather than about the technicalities of particular financial solutions. In the case of Hong Kong, intervention by the Hong Kong Monetary Authority in the equity market had been perceived as out of character with the free market nature of Hong Kong. He noted the capital controls and other economic measures announced by Malaysia but said the most significant development since the last Court meeting was in Latin America, where there had been clear signs of contagion, particularly in Brazil. This was a cause for concern.

The Americans had been spurred into action, which was reflected in the G7 statement over the previous weekend.

Sir Chips Keswick noted that it was not yet known how much the banking system had lost in the derivatives market, and he believed the banking risk was very real. He expected more black holes to appear, which would create an international stability problem. Mr Davies said that the FSA monitored very carefully the exposures of its institutions, which included a number of non-UK parented institutions that banked through London. On the face of it the impact was relatively limited. There were one or two institutions being baled out by their parents, which were banks from third countries. Overall, exposure to Russia was not enough to cause the FSA to think that that, by itself, was a threat to financial stability in London.

What could not, however, be ruled out was emotional contagion. Mr Davies noted that there were reasons inherent in the Brazilian situation which explained why Brazil should come under the spotlight, but they did not apply to Argentina, even though that country had also come under the spotlight. He said that he had just come overnight from an international meeting of securities regulators in Nairobi. With the exception of the continental Europeans, who regarded what was happening as a correction, everybody else was extremely nervous and had no confident view of any kind of recovery. He noted the trend in some countries towards measures that restricted market activity.

The Governor commented that there was a recognition that intervention - whether in the stock market, as in Hong Kong, in maturity extension, or in controls on residents' capital transactions - was likely to be seen by some countries as the least bad of all possible alternatives. The question was whether that was left to happen at random or whether it could be embraced sensibly in a more co-operative framework which could be taken on or endorsed by the international authorities. Short run action should nevertheless be continued, to buy time to implement more important changes, either on the supply side or on the structural side. These issues would move closer to the centre of the international debate, and were very much tied to the question of making more finance available. It was clear that international financing on a scale that could make these developments unnecessary seemed unlikely, partly because the US Congress was not prepared to take action. There were also risks, in that financing might immediately flow out again and encourage the purchase of foreign exchange by residents.

These two aspects, the provision of more finance and changes in the approach to debt rescheduling, were coming together. However, everybody was clear that a unilateral freeze was probably the worst possible option.

Commenting on credit crunch issues, Professor Buiter said that he believed some of the increases in spreads were probably necessary and permanent. In cases such as Brazil where there was a fundamental underlying economic problem, a large part of the spread could be explained that way, but this did not apply to Argentina. In general, he suggested that the international response should be, at the very least, a more relaxed approach to the use of capital and foreign exchange controls for non-capital account transactions than the IMF had seemed until recently to be pushing for.

Mr Allsopp noted worries about the possible connection between financial panic and the underlying situation, and wondered whether there would be a quick bounce - like Malaysia - or whether it would take a very long time, like Japan. Mr Neill commented that the numbers looked so horrible that he could not understand whether the problem was soluble or not. Dr Julius said that she believed that for the next two years there was not going to be a significant bounce back in the international economy, but it was still very hard to see the end game. In reply to Mr Allsopp, the Governor said that it was possible to envisage nightmare scenarios, but it was important to recognise that the situation in the United States was reasonably robust. There might be a slowdown in activity which might be aggravated by a weakening in the stock market, but if that were the problem then it was addressable by the US. If the US concluded that in a global context it should increase aggregate demand in the United States, then it could do so. The same applied in Europe, where domestic demand was beginning to pick up. Europe was in a better position to start with, having an external surplus. He believed the general perception was that there would not be an immediate plunge into a global nightmare, and he noted the importance of Japan, where there was agreement at least in principle on what should be done, both in terms of measures for the banking system and in terms of fiscal stimulus. But Japan was very resistant to outside pressure. He also noted the difficulty of making more liquidity available from the major economies. Additional financing for the IMF was stuck in Congress. However, there was much more likelihood that the US would make available additional liquidity as the problems moved closer to home, into Latin America. The Governor noted the importance of the contribution of the private sector

through maturity extensions, and he commented on the possible spread of exchange controls. He believed there was emerging agreement on the potential severity of the problem and also on the institutions and actions needed to try to contain it. He shared the view that for the time being the world was not leading into a global slump of the type experienced between the wars, but it was not a comfortable situation.

Sir Colin Southgate commented that he had never seen a situation this severe and he believed forecasts of a bounce back were nonsense.

FSA Legislation: "Meeting our Responsibilities" (Messrs Plenderleith and Clark in attendance)

Mr Davies introduced his paper entitled "Meeting our Responsibilities", which followed a draft of the Financial Services and Markets Bill published at the end of the Parliamentary Session on 30 July. He gave an explanation of how the FSA propose to proceed, drawing out ways in which the FSA would, in future, work with and alongside the Bank. He said that the key issues were achieving a good market response to the draft, and whether the Government would find enough time for the legislation. Drawing Court's attention to the document published by the FSA, he noted that as far as possible it described a single regulatory regime; it was essentially a piece of flexible framework legislation (which was why the "meeting our responsibilities" paper had been produced to show how in current circumstances the FSA would carry out its work); and there was a set of statutory objectives which included the maintenance of market confidence and of financial stability, set out in paragraph 38, which could only be delivered by working with the Bank. There was also a list of "things that must be taken into consideration", including a requirement for the FSA to regulate efficiently, to regulate by proportion, to take account of the responsibilities of managers of firms, and also to take account of Britain's position as a financial centre by not impeding the development of the London markets. This last point was another link with the Bank of England's core purposes. Finally, the FSA would have a Non-Executive Directors Committee similar to that in the Bank of England Act.

Turning to organisation, Mr Davies said there would be a single regulatory structure, including friendly societies, building societies and the insurance directorate at the DTI which would all be joining in January. He said he was confident that FSA staff still in the Bank of England Head

Office would leave before the FSA's commitment to get them out by the end of the year expired.

Dame Sheila Masters asked whether Mr Davies' "list of things that needed to be taken into consideration" opened the possibility of judicial review, thereby making the process more difficult to operate. Mr Davies said this was a possibility, and there had been quite a lively argument about whether the points should be couched in that form or not. Ministers had decided they should be. The risk of judicial review was mitigated because the legislation was drafted so that these considerations applied to the FSA's general functions. An individual institution could not say that a restriction on its capital, for example, affected its competitive position in the context of London as a financial centre. He regarded the list as reasonable, given the breadth of the FSA's powers, and did not believe it would affect decisions on individual institutions. Mr Clementi said that such an outcome was satisfactory for the Bank, and he noted that while the competitiveness of the City was a core purpose for the Bank of England, for the FSA it was something that had to be taken into account. In response to a question from Mr Buxton, Mr Davies said the timetable, so far, was as the Government had indicated. He noted that, in the event of a delay, the Commons had now agreed that in principle that once a Bill had reached a second reading it could be carried over to the next session. He also noted that the process of revising rule books and other work would take until early 2000, so on this timetable full implementation and the passage of the legislation would happen at the same time. It was no secret that the FSA would have preferred enabling legislation followed by a separate Reform Bill, but the Treasury had judged that if the FSA had got the former there was a risk that the second might not happen.

Ms McKechnie commented that there were a number of points that would be really problematic for the retail sector, and she believed there was going to be a very much greater fight than so far realised. Areas of concern included caveat emptor, the definition of consumer and some of the fundamental approaches to retail regulation. Unfortunately, the Treasury had not consulted before publication or they would not have walked into some of the stupidities in the Bill. There was deep concern that the new regulatory framework would not reform the retail financial sector in the way that was required, and there was also concern that the Board of the FSA was balanced towards industry interests and unbalanced towards consumer representation, so it was not going to protect the consumer in the way that had been hoped, after the lessons of the last

10 years. Mr Davies said he was not going to presume on the Court's patience to answer the points, though he believed he could do so.

FINANCIAL MARKET OPERATIONS ISSUES

CGO/CMO/CREST Merger (Messrs Plenderleith and Clark in attendance)

With reference to a Minute of 19 August, Mr Plenderleith updated Court on the CGO/CMO/CREST merger ahead of the planned public announcement expected in the near future. He said that there were three steps. CREST would take over the running of CGO and CMO as soon as they could negotiate legal agreements with the users and the banks. It was hoped to do this by Easter. CREST would be owners, and responsible for running the operations, but they would be run as at present on Bank premises, with Bank staff working alongside CREST people, on Bank hardware. In the second stage, in the later part of next year, it was hoped to shift CMO to CREST's premises, and Bank staff would stand down. In the third stage, by mid-2000, it was hoped to shift CGO to CREST premises, and integrate it with CREST. Mr Plenderleith hoped the market would notice no difference. As Bank staff were released from this arrangement, the Bank believed it would have more than enough to occupy them, not least on the huge backlog of IT work after EMU and the Year 2000. He noted that the Bank would continue to operate the depository for CREST, and charge for it.

There were technical difficulties in merging money market settlements into gilts and equities, so in the year before the move the Bank would conduct a review of the structure of money market instruments to make sure that it took place cleanly. Mr Plenderleith noted that CGO and CMO were a classic example of the third core purpose in operation, where the Bank could make a contribution to the efficiency and effectiveness of the financial system. CGO and CMO (and indeed CREST) had been developed by the Bank after the market had failed to develop the necessary systems - the Bank filling a gap and then passing the systems back to the market when it was ready. Mr Clark said that this was one step in quite a long history of improved settlement structures in London. There were a number of other recommendations of the security settlement review which were still on the agenda, related more to trying to reduce risks, whereas the CREST merger was concerned more with cost and efficiency. In reply to a

question from Mrs Heaton, Mr Plenderleith said there were no direct implications for Registrars immediately, though further down the road it would be necessary to think through whether it was sensible to have both CGO and Registrars as separate systems. This would be reviewed. In reply to a question from Sir David Cooksey about the implications for mergers among the European stock markets, Mr Clark said that CREST was in discussions with other national settlement systems and hoped to have some input to the discussions between the London Stock Exchange and DTB. CREST felt that it would be in a stronger position to take the lead within Europe if it were handling a range of facilities, and not just equities.

Executive Report - (Mr Plenderleith in attendance)

With reference to a Minute of 17 June 1998, Mr Plenderleith reported to Court the actions taken with regard to the members of staff involved with missing bills in CMO, and his concerns about staff resourcing. He said that it was a disagreeable episode. The Bank had become extremely concerned when indications emerged that not just one bill but possibly others had been lost. When it became clear that the Bank was not dealing with an isolated incident it suspended six staff in the depository function. Internal Audit was asked to do a full stocktake and a full enquiry was set in motion. The Bank was satisfied that there was no criminal intent and the bills had not reappeared. Neither did the Bank believe what happened was deliberate or sabotage, rather it was the result of accidental errors and the bills were most likely to have been destroyed along with confidential waste. The situation was ascribed to a combination of poor management in the section compounded with inexperience on the part of the supervisor - whose first appointment as a supervisor this was - and of his staff, who were part-time. They were probably not adequately trained and resources were stretched, being directed at the time to the Central Gilts Office new computer system. The Bank had taken steps to correct the deficiencies, and would try to make sure that the improvement was maintained.

Turning to disciplinary measures, he said a formal warning had been given to three of the four juniors and a more informal warning to a very young junior. If there were any further failures in standards, the Bank would have the right of dismissal. Turning to the supervisor and his deputy, the Bank had considered whether to regard it as gross misconduct, leading to immediate dismissal, but had concluded that this was not appropriate because of the factors indicated, including the stretched resources, the fact that the area was under stress and that the

supervisor was inexperienced. So the Bank had concluded that there had been serious negligence and had effectively demoted both, and transferred them to work elsewhere in the Bank. They had pleaded that they were under stress; they were certainly out of their depth, but it was part of their responsibility to seek help. Discussions were taking place with senior management on how to prevent such stress arising. The lesson drawn was that the Bank needed to ensure that it was properly resourced for the work it had to undertake.

In reply to a question from Mr Buxton, Mr Plenderleith said that the three bills were dated, and he believed one - a six-month bill - was still in date. The market had been warned. There was no evidence that it was going to reappear. In reply to a question from Sir David Cooksey, Mr Plenderleith said that the face value of the three bills was between £5-£10 million, (one alone being £5 million). Dame Sheila Masters asked about enquiries into the management to which the supervisor reported. Mr Plenderleith said that this would be reflected in management's annual appraisals, which would consider whether they had allowed their attention to be diverted to the computer up-grade, thereby neglecting the need of the supervisor for closer oversight. It was reasonable, however, to expect a supervisor who had been twenty years in the Bank to draw management's attention to a problem. Mr Neill said that in the real world things went wrong, and he drew comfort from the fact that the problem had been brought to Court's attention immediately, thoroughly investigated and in no way covered up. The Governor said that it was important that it had been investigated thoroughly and action taken.

Foreign Exchange Swaps

Mr Plenderleith reminded Court that it had agreed to a limit of £2 billion on foreign exchange swaps last year, which was temporarily increased to £3 billion at the turn of the year. He asked authority for a temporary increase to £3 billion to the end of March 1999, when there would be an even bigger concentration of tax payments than in 1998. Court was content.

MANAGEMENT OF THE BANK

Executive Report (Mr Plenderleith remained in attendance)

At a meeting of the ECB's General Council in Frankfurt on 1 September, the Governor advised Court that the ERM II agreement between the ECB and the 'out' central banks had been signed, and had been published by the ECB on 11 September. He said that he had signed on behalf of the Bank. He had explicitly made clear that participation in ERM II would be voluntary for non-Euro area members.

Executive Report

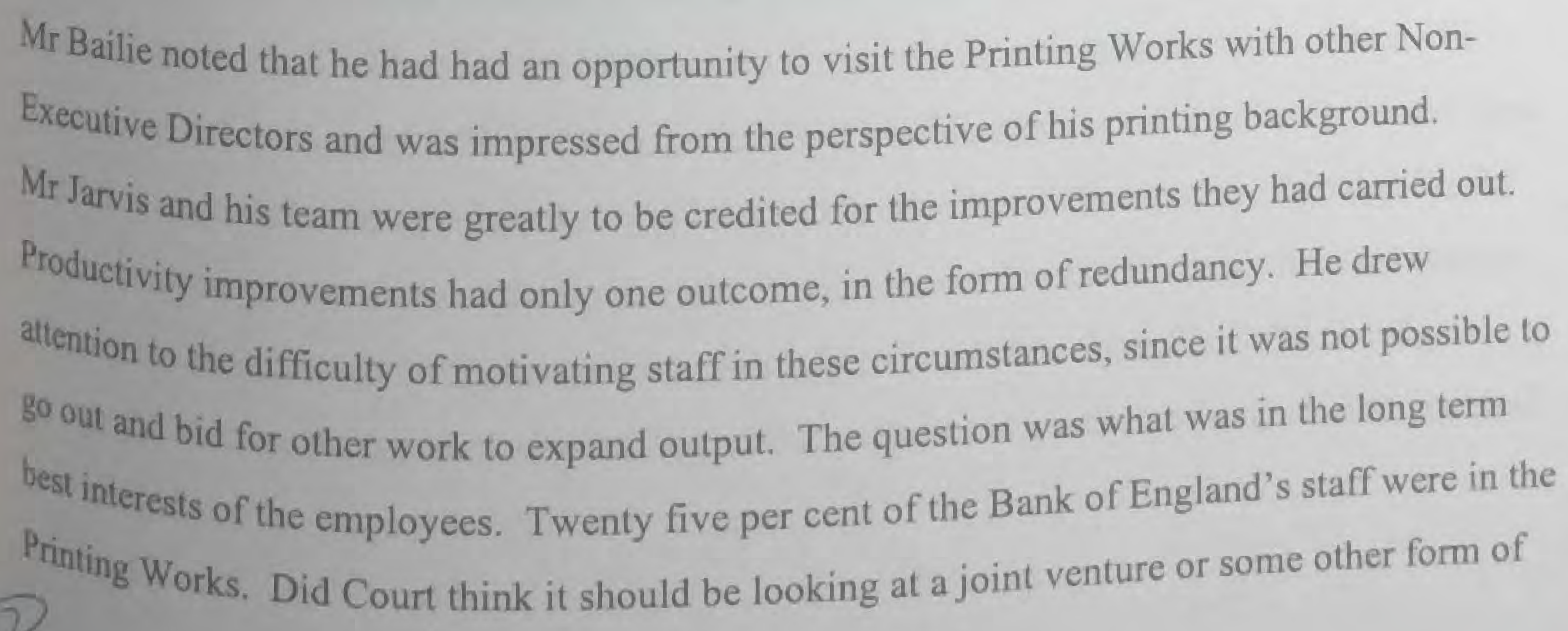
The Governor, in turning to the question of whether to hold a meeting of Court outside London, wished to canvass the views of Court as to whether, in principle, they thought it would be a good idea. Birmingham, where the Bank had an Agency, had been suggested as a possible venue. He asked whether Court would agree to convene a meeting outside London occasionally, perhaps initially on an experimental basis. This had not been done before, but if Court was agreeable the Bank would explore the practicalities. If Birmingham were chosen, it would be on a normal Court day. He believed it had the advantage of accessibility. The Governor envisaged a Court meeting and a lunch with some of the local business community, to show that the Bank of England was not Threadneedle Street-centric. Mr Allsopp asked whether Birmingham was far enough North. The Governor said that if it worked reasonably well in Birmingham then the Bank could explore visiting other parts of the country. In reply to a question from Mrs Heaton, the Governor said he would not envisage meetings outside London more often than once a year. Court was content, and the Governor said that the Bank would go ahead and look into the practicalities.

Report from the Printing Works (Messrs Plenderleith and Jarvis in attendance)

Mr Jarvis said two events during the year had had a significant impact. The first was the Bank's decision to close four branches and move issue and sorting to the clearing banks, and concentrate on the Leeds and Debden cash centres. The second was confirmation of the decision not to be in the first wave of the Euro. The cash centre changes had allowed the Bank

to release a number of notes in store to the market, so note production was about 10% down on previous years, and the underlying volume would be lower still. The outlook depended on whether the Treasury agreed with the Bank's desire to introduce new variants of the £10 and £20 notes. An upgrade was desirable because the existing notes were unprotected compared with the Euro. The new variants would be a short term boost to production, which would be 1.25 billion for the next couple of years, settling down to between 1.1 and 1.15 billion notes a year. The Printing Works had been running a continuing programme of improvement without compulsory redundancy, but was now running out of volunteers for early retirement and voluntary redundancy, so achieving staff savings was going to be more difficult in future. The Printing Works had just joined the CBI bench-marking programme and would be doing targeted bench-marking. Comparative work had been undertaken with De La Rue on the Indian contracts.

Turning to the Euro, Mr Jarvis said the Printing Works was actively involved in finalising the design, in origination and in plate, ink and thread-making; and was soon to be involved in a pre-production run, which provided another opportunity to bench-mark. The main difficulty was that the Euro would have some upgraded features compared with existing sterling notes. He showed two sets of Euro notes to Members of Court. Mr Jarvis noted that the reflective foil required specialised application equipment. The Bank had one machine and would shortly be purchasing another to upgrade the £10 and £20 notes. On the back of the Euro note was either an optically-variable ink design (high value) or an iridescent strip (low value) which required silkscreen printing equipment which could not be bought now, because it would not be needed unless the UK joined EMU. The trick was to be fully equipped for the Euro launch without purchasing the kit.



Mr Bailie noted that he had had an opportunity to visit the Printing Works with other Non-Executive Directors and was impressed from the perspective of his printing background. Mr Jarvis and his team were greatly to be credited for the improvements they had carried out. Productivity improvements had only one outcome, in the form of redundancy. He drew attention to the difficulty of motivating staff in these circumstances, since it was not possible to go out and bid for other work to expand output. The question was what was in the long term best interests of the employees. Twenty five per cent of the Bank of England's staff were in the Printing Works. Did Court think it should be looking at a joint venture or some other form of

alliance with the private sector which hopefully would remove the impediment of bidding for contract work? In the absence of that, Mr Jarvis and his team had only one thing to do, which was to chip away at costs. Mr Bailie asked the Court's view on this question. Mr Bailie also noted that he was a member of the Printing Works Advisory Board.

The Governor thanked Mr Bailie for the interest he was taking in the Printing Works. Mr Jarvis, in reply to a question from Mr Buxton, said that in international terms having a banknote printing works was a bit like having your own airline. Ireland had a printing works with an output of only 100 million notes a year and a lot of others had output levels of 200 million or less, which did not justify having a printing works. A break-even level was 4-500 million notes a year. The larger printing works in Europe were France, which had slightly less output than the UK but three times the staff; Spain, which was State owned, with a similar volume to France and a few more staff than us; Germany, with one state banknote printing works and one private; and Italy, with twice the staff and slightly less volume. When planning production of the Euro note, there had been a suggestion that there should be a pooling but this was unacceptable for political reasons because of concern about potential works closures. It seemed sensible to find partners in Europe, but this was not feasible at the moment. There was over capacity in the international banknote market and any attempt to win extra business had to be seen against that background.

Mr Neill said that to engage people they must believe that there was a future for them. He would be very sympathetic if the Works was able to go out for new business. They had to bench-mark against the best in the world, not against the mediocre. In principle he would be very supportive. Mr Jarvis noted that Debden Security Printing (DSP) had been set up to increase the freedom of the Printing Works to do new business.

Sir David Cooksey asked whether a lack of progress on automatic note inspection had been slowing progress on the staff front. Mr Jarvis said the Printing Works' first machine was now working well on line, and another two were due for delivery in the first half of 1999. The works would be able to shed examination staff and in anticipation had been taking people on short-term contracts. This applied to about 40 staff. Mr Davies commented that banknote printing was an odd market because purchases were nearly always by sovereign states, and it was the view of most countries in the developed world that they should keep their own banknote printing capacity. The first that reduced capacity ran the risk that others would keep capacity. That might not continue in Europe in the longer or medium term, when the inefficiency of printing seven notes in 15 places became more apparent, which would lead to rationalisation. If Britain joined EMU, that would be a very good moment to take the lead in some European restructuring of the banknote printing market. In the meantime there were actions that could be taken at the margin, for example the Indian contract. He did not see that as an intellectually perfect position, but it was where he had ended up when he had considered the matter in the period when he was responsible for the Printing Works. It was necessary to work incrementally and get extra volume, and hope that in three or four years there would be an opportunity for a European restructuring.

Mr Hawker endorsed Mr Bailie's comments on the visit to the Printing Works and said he was very impressed. Mr Bailie said he was sure that Mr Davies was correct, and he noted that he was looking for permission to investigate further with Mr Clementi and Mr Jarvis. The Governor invited Mr Bailie and Mr Clementi to discuss with Mr Jarvis and others how future productivity gains could be achieved with declining demand, and come back to Court on their findings. He said he also agreed with Mr Davies. It was untenable that all 15 countries kept their Printing Works. This system would break down but not in the immediate atmosphere of sensitivity about such issues. In reply to a question from Dame Sheila Masters, the Governor said that the Bank could re-examine the self-denying ordinance about not competing with De La Rue. Mr Clementi noted that there were actions that could be taken in the banking business but they were not taken since the self-denying ordinance covered the whole banking business. The Governor noted that the issue should be looked at only in the context of the Printing Works. The Governor agreed with Mr Bailie that the private sector would cry foul if publicly-funded organisations came out in competition with them.

The Governor left to greet the Lord Mayor of London and handed over the chair to Dame Sheila Masters, who invited Mr Clementi to continue the Executive Report.

Executive Report

Mr Clementi reported to Court that Mr Morris had agreed to become a Trustee of the Staff Pension Fund and Court APPROVED the appointment.

Personnel

Turning to personnel matters, Dame Sheila Masters sought Court's approval for changes the Bank proposed to make at senior management level affecting Deputy Directors and some Heads of Division.

The changes, which would come into effect on 1 January 1999, were as follows:

1 Merlyn Lowther would succeed Graham Kentfield, as Chief Cashier, on his retirement at the end of the year.

2 John Townend would take up a new position as Director for Europe.

3 Bill Allen would switch from being Deputy Director, Monetary Analysis and take on John Townend's role as Deputy Director, Market Operations.

4 Nigel Jenkinson, currently the Head of Structural Economic Analysis Division, would be promoted to Deputy Director, Monetary Analysis.

5 John Footman would succeed Merlyn as Director of Personnel and in this role both Personnel Division and Secretary's would report to him directly.

6 Finally, Paul Tucker, currently Head of Monetary Assessment and Strategy Division would be promoted to Deputy Director and take over John Footman's position as Deputy Director in the Financial Stability area.

Court APPROVED the changes.

Mr Clementi added that these changes left some vacancies amongst Heads of Division and he hoped to be able to comment further at Court in October.

Mr Clementi noted that some titles, such as Director of Finance and Director of Personnel, had the status of a Deputy Director. In reply to a question from Mrs Heaton, Mr Clementi confirmed that Ms Lowther went, on promotion, to the level of Deputy Director. Chief Cashier was one of the most visible jobs in the Bank. In reply to a question from Sir David Cooksey, Mr Clementi confirmed that Mr Kentfield was retiring early. He said he had done a wonderful job and had served the Bank extremely well. Mr Kentfield felt the time had come to move on. Ms Lowther had been his Deputy for a number of years and it was a very natural progression.

A recommendation from the Chairman of the Remuneration Committee

With reference to a Minute of 19 August, it was agreed that Court should return to the unresolved issues highlighted at Court in August relating to pensions for Chancellor-appointed MPC members and Advisers to the Governor. Sir Colin Southgate said Court had been concerned about two issues. Mr Buxton had raised the question of the investment rate, which Sir Colin clarified was not strictly speaking an investment rate but was in fact the average ratio of immediate and deferred annuities, taking into account life expectancy. The use of the word investment was perhaps misleading. The rate, 1/2% plus inflation per month, was the one the Bank had always used. Mr Buxton said that if Sir Colin believed that this was all right he would accept it. The operation of the pension cap had been raised by Sir Neville Simms. As the pensions concerned would be in the Staff Fund not the Court Fund, the cap applied. As the Bank did not go above the cap in the staff scheme this was not therefore an issue. Sir Colin then outlined the Remuneration Committee's recommendation which read as follows:

For those under 60 years of age: the option of either pensionable service as a member of the Staff Pension Scheme, or non-pensionable service plus a supplement of 15% of salary.

For those over 60 years of age: those over 60 joining the Bank for the first time, non-pensionable service plus a supplement of 15% of salary. For those over 60 who have previously undertaken pensionable service as a member of either the Bank Staff or Court schemes, the amount of their pension to be increased by a late retirement factor plus RPI until brought into payment. (This last provision meant that pensions would be taken at the age of 60, but payment would be deferred, as a result of leaving pensions in the Bank Staff Fund after retirement age. The amount to be paid on eventual retirement would increase annually at the investment rate - currently 6% plus inflation pa). For those over 60 who had previously undertaken non-pensionable service at the Bank, further non-pensionable service plus a supplement of 15% salary.

In all cases, individuals would receive death-in-service benefits.

All existing staff in this group would be reviewed following the introduction of the new arrangements, and the principle of grandfathering would be applied to the extent that no-one would be worse off in terms of the benefit they received.

Court APPROVED the recommendation.

Dame Sheila noted the Governors' engagements in Directors' papers.

Court rose.

Sheila Masters

Peter Rodgers

13 October 1998

A COURT OF DIRECTORS AT THE BANK

TUESDAY 13 OCTOBER 1998

Present:

Mr George, Governor
Mr Clementi, Deputy Governor - Financial Stability
Mr King, Deputy Governor - Monetary Stability
Dame Sheila Masters, Chairman, Sub-Committee of Directors
Mr Allsopp
Mr Bailie
Mr Buxton
Sir David Cooksey
Mr Davies
Mr Hawker
Mrs Heaton
Sir Chips Keswick
Sir David Lees
Ms McKechnie
Mr Morris
Mr Neill
Sir Neville Simms
Sir Colin Southgate
Mr Stretton

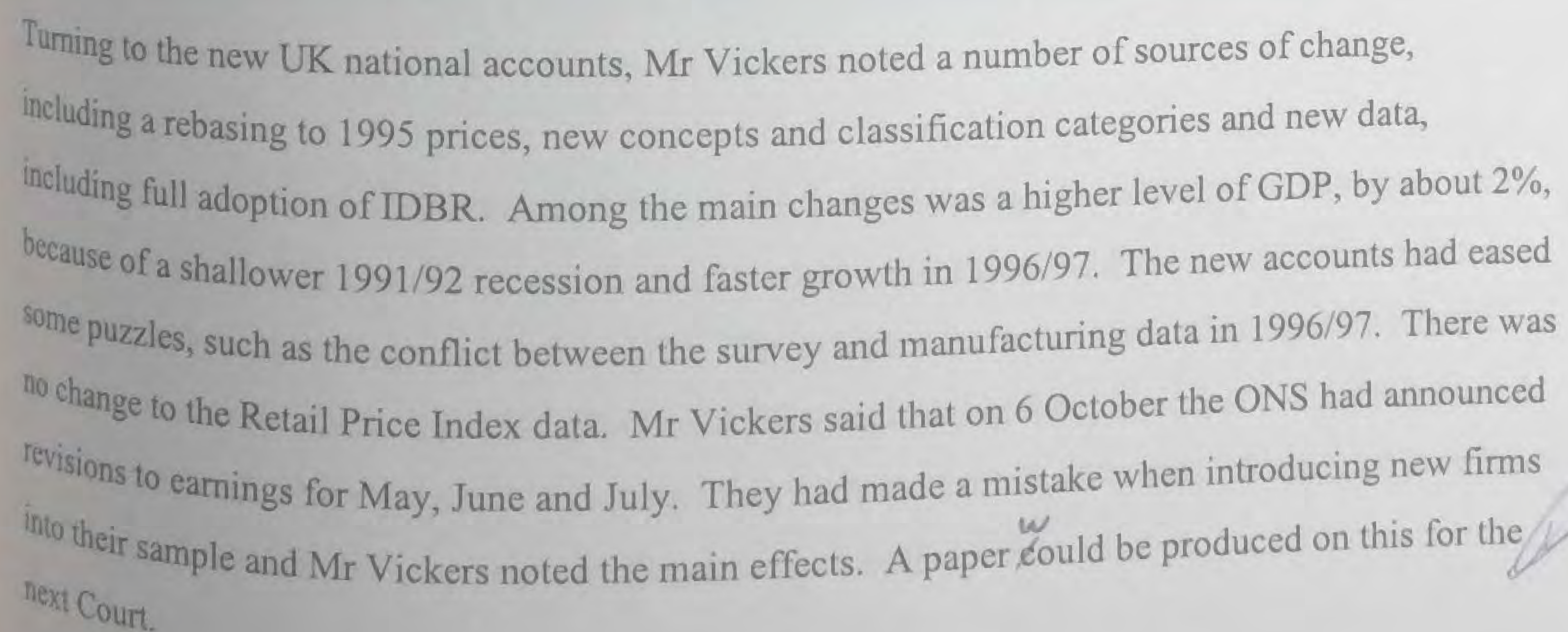
The Minutes of the Court of 16 September, having been circulated, were approved.

MONETARY STABILITY ISSUES

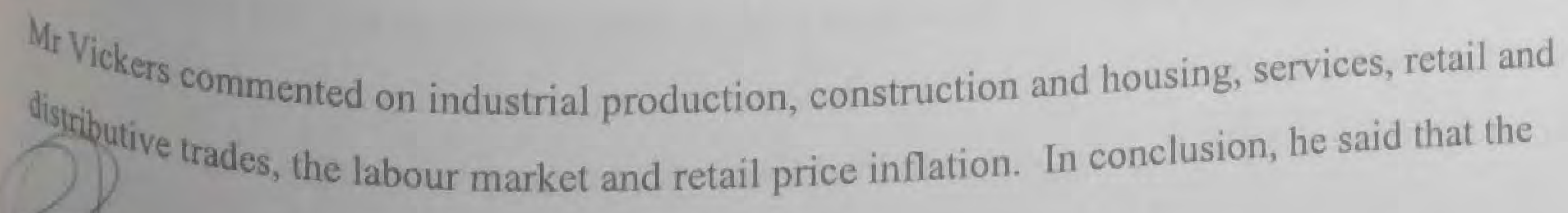
Economic and Monetary discussion, incorporating the monthly MPC report to Court (Messrs Vickers and Plenderleith together with Dr Julius, Professor Buiter and Sir Alan Budd in attendance)

The Governor said that the Minutes of the meeting of the Monetary Policy Committee in September were not published until the following day but were available to Members of Court in their folders. He noted that they were market sensitive and asked Members of Court to leave the minutes in their folders when they left.

Mr Vickers noted that the meeting was a day earlier than usual so there was no labour market data and the rebased data would be available the following day. But there was no shortage of news, both domestically and internationally. On the domestic front, in addition to the usual monthly official survey data there were the new national accounts from the ONS, revisions to recent earnings data and the 25 basis point rate cut in October accompanied by a statement. Internationally there had been a number of downwardly revised forecasts, notably from the International Monetary Fund in its Autumn World Economic Outlook, which noted among other points that world output growth was projected at 2% in 1998 and 2.5% in 1999, a reduction of more than 1% since May. There had, of course, also been remarkable market turbulence.



Turning to the new UK national accounts, Mr Vickers noted a number of sources of change, including a rebasing to 1995 prices, new concepts and classification categories and new data, including full adoption of IDBR. Among the main changes was a higher level of GDP, by about 2%, because of a shallower 1991/92 recession and faster growth in 1996/97. The new accounts had eased some puzzles, such as the conflict between the survey and manufacturing data in 1996/97. There was no change to the Retail Price Index data. Mr Vickers said that on 6 October the ONS had announced revisions to earnings for May, June and July. They had made a mistake when introducing new firms into their sample and Mr Vickers noted the main effects. A paper could be produced on this for the next Court.



Mr Vickers commented on industrial production, construction and housing, services, retail and distributive trades, the labour market and retail price inflation. In conclusion, he said that the

external environment had deteriorated further and there had been extraordinary market turbulence. Domestic official data, from the ONS and from the money figures, was not weaker than expected. The necessary slowdown was on track according to those data. But domestic survey data and reports from the Bank's Agents did give a substantially weaker picture.

Commenting on the markets, Mr Plenderleith said that he had suggested in Court a month before that the disturbance sweeping through financial markets since the Russian default in August involved three processes: a generalised retreat from risk, a fall in the major stock markets levels and an adjustment between major currencies, particularly the dollar weakening. These had been the continuing themes, along with a fourth, which was the absence so far of any co-ordinated international official initiative which the markets might see as aimed at addressing instability in the markets. There was particular disappointment in the markets that nothing concrete had come out of Washington.

He drew Court's attention to chart 10, showing spreads had fallen a little back from their peak but had then reversed during the previous 10 days. This had manifested itself particularly in a violent swing of the yen as shown in chart 1. This had been precipitated by the cutting out of a range of positions in long dollars financed by yen borrowing. It involved not just hedge funds but investment banks, and had been precipitated by losses some of these investors had made in emerging markets. They felt they needed to cut their yen:dollar exposure, particularly since the yen was rising, which in turn precipitated a further rise of 10-12 yen in a few hours.

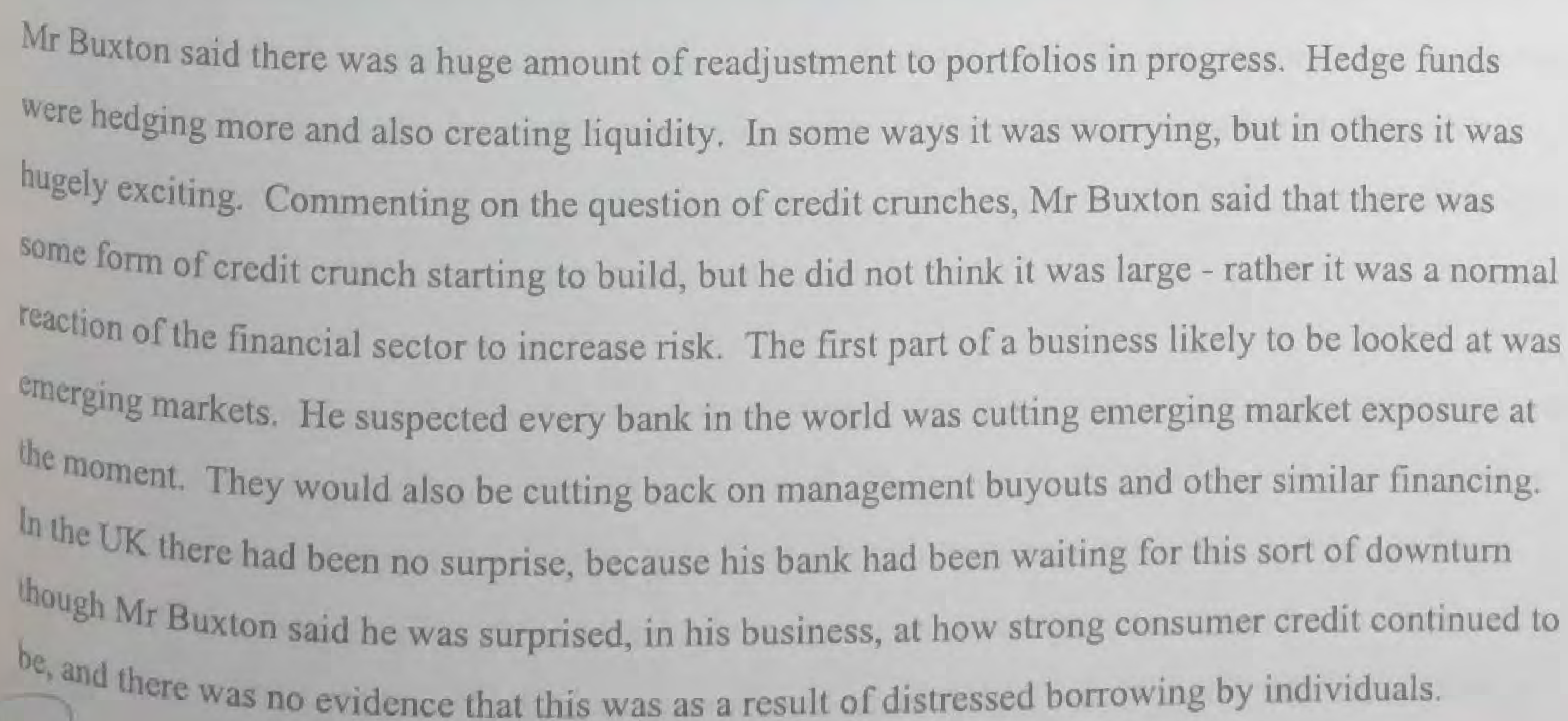
The situation developed further the week before the Court meeting. In the most extraordinary series of events in the market that the Bank had seen for some time, there had been a sudden downturn in the bond markets including a squeeze on gilts. The market turn-around was illustrated by chart 7. Investors were realising their profits. They sold the longer end of the gilt market and went into cash or the shorter end. The yield curve was steepening in front of the Bank's eyes. The pound was down to the upper DM2.70s, led very much by the movement of the dollar.

Mr Plenderleith said that he did not claim fully to understand the forces driving the markets. On the bleak side, it was very hard to see how markets driven by these sort of shocks were going to stabilise in the short run. On the other hand, the Japanese Parliament may be adopting a stabilisation package

for the financial system, the US Congress was near the point of approving new funds for the IMF, it was possible that Brazil might be able to come through the present crisis, and all these developments might help gradually to reduce some of the tensions in the markets. It was also true that there had not so far been a failure of any major banking institution. It was more probable than not that there would be serious casualties, by the nature of these things, but the Bank was not aware of any significant institutions in trouble. If Japan, the IMF and Brazil came through, then the markets might gradually stabilise and risk-taking might return to the market, although at a higher price. Equally, there was a possibility of new shocks. The situation was very much on a knife edge.

Mr Allsopp asked whether there was evidence on the extent to which there was a distress response taking place to losses on the yen, as opposed to a change in market sentiment. He found the situation baffling, and one of the most worrying he had ever seen.

Mr Plenderleith said there were two stories in the market. The major one was that it was an adjustment to risk, and to losses elsewhere. But there was certainly a minor theme that the steepening in the yield curve in the UK and elsewhere resulted from a market perception that central banks around the world were going to lower interest rates rapidly in the face of weakness, governments would be inclined to increase public spending to offset weaker growth, with the prospect of greater inflationary risk causing bond yields to rise. Mr Plenderleith said that he did not wholly believe the second story, and thought the explanation was to do with risk adjustment, though he would not be confident about that.



Mr Buxton said there was a huge amount of readjustment to portfolios in progress. Hedge funds were hedging more and also creating liquidity. In some ways it was worrying, but in others it was hugely exciting. Commenting on the question of credit crunches, Mr Buxton said that there was some form of credit crunch starting to build, but he did not think it was large - rather it was a normal reaction of the financial sector to increase risk. The first part of a business likely to be looked at was emerging markets. He suspected every bank in the world was cutting emerging market exposure at the moment. They would also be cutting back on management buyouts and other similar financing. In the UK there had been no surprise, because his bank had been waiting for this sort of downturn though Mr Buxton said he was surprised, in his business, at how strong consumer credit continued to be, and there was no evidence that this was as a result of distressed borrowing by individuals.

Consumer borrowing was still rising at 14%-15% a year, though he believed it would drop off the shelf sooner or later.

The Governor noted that the issue for the Bank was the timing of any credit crunch that might occur in the domestic economy. Mr Buxton said he had no impression of a general cutback, even though there were cutbacks at the margins. Sir Colin Southgate noted that several management buyouts had been pulled in the United States. Mr Buxton said there was not a crunch in general commercial banking. Mr Davies said that it was possible to see a flight to safety, which was extremely rapid, with yields bid down a long way so that the carrying cost of safety was quite high. He expected some movement back, but that did not explain the suddenness of what occurred. He saw hedge funds as quite an important part of the picture but the sector was contracting because of losses and the trend to reduced leverage. Turning to the position of financial institutions, Mr Davies said he could not see a significant UK institution in serious trouble but would expect a pretty big shake out in investment banking over the next few weeks or even days. The third quarter looked gloomy, with the possibility of mergers and job losses. Dom Perignon futures were not the place to be.

However, in the retail sector in the UK, there had been precious little impact. Overall, consumer credit and personal investments remained rather high. It was very much an investment banking story. Mr Bailie commented that confidence was lower than the reality at the moment and had been further eroded during the last few weeks. If there were not some stabilisation in the market there could be real damage to the economy, because people would hold back on investment.
Ms McKechnie noted the substantial difference between the US and Europe in consumer exposure to the equity market. It was the operation of the housing market in the UK that triggered fast consumer reaction. Mrs Heaton commented that there appeared to be inconsistency between Mr Buxton's remarks about consumer credit and reports in newspapers that retailers were having a very difficult time, for example in the kitchen and bathroom sales.

The Governor commented that the key issue for the Bank was that, when examining data - which was intrinsically backward-looking - one picture appeared. But when looking at forward expectations, a confidence effect was apparent. Judging how far that would translate into behaviour was difficult. Sir David Lees commented that it was too early to draw many conclusions. It had been a two month phenomenon in the markets, of which one month was a holiday period. If Court was having these

conversations in two months' time it might be saying different things. Behind the scenes, businesses were looking a budgets and cutting investment intentions and these changes would flow through in the weeks ahead. The agricultural sector was having a bad time and Sir David believed that banks would have some interesting experiences with their farming customers. Sir David Cooksey noted that there were very high prices for management buyouts in early 1998 and late 1997, but bank financing had now almost gone. Commenting on reports of difficulties in the retail sector, he noted the Marks & Spencer had damaged themselves quite badly by failing to keep up with design trends and were caught with stock that they could not shift. The rest of the clothing market was not suffering nearly as much as Marks & Spencer. He also noted that below the FTSE250 level, price earnings ratios were falling below five and yields were 12%-13%. Given the extent to which companies were unborrowed, this was an extraordinary reversal and could not be sustained over time. It had to come right. He also noted that suppliers of temporary and contract staff to the information technology industry reported demand falling off the cliff, particularly in financial services and similar industries. Only three months ago they were unable to meet demand. This was a real signal of the way the services sector was going into reverse.

Commenting on a point made by Ms McKechnie about the cost of pension guarantees, Mr Stretton said that a competitive life company, when it sold a guarantee, made an actuarial reserve for it. For the many companies that had done that properly, this was not an issue. If the ~~Government~~ Company's Actuary was doing his job properly, this was not going to be a problem. If a company sells a guarantee, a charge is made based on the probability that interest rates will be less than the key level. The charge was not pocketed but kept in reserve and that was what good actuaries and good companies did. Mr Vickers noted that the price of annuities had increased sharply which had possible implications for the savings ratio and other factors. The effects could be quite substantial and were very much in the monetary stability domain, not just that of financial stability. Mr King noted that a year ago there was widespread talk about the overvaluation of the equity market and some said that the only thing to fear was the lack of fear. This year the opposite was true, since the only thing to fear was fear. However, he noted that the equity market was virtually at the same level as a year ago and in the meantime it had been up very sharply and down again. It was very difficult to come to simple conclusions. On the immediate question of whether there would be a credit crunch, the Bank would have to monitor very closely.

MPC procedures (Messrs Vickers and Plenderleith together with Dr Julius, Professor Buiter and Sir Alan Budd in attendance)

Introducing the discussion, Mr King said the paper spoke for itself. He noted that there was a statutory responsibility for Court to review procedures, delegated to NedCo. The Non-Executive Directors would be expected in the Annual Report to report to Parliament and the public more generally on their views about the procedures of the MPC. Therefore it was sensible not to leave a review until the last minute. The paper suggested a timetable for future Court discussions. He noted that Professor Buiter had expressed some concern that the implication of having the discussions in Court, not in NedCo, might be to give undue weight to the Executive members of the MPC which he did not believe was desirable. The Governor commented that this was a matter for Court and NedCo. Dame Sheila Masters said the paper had been discussed in draft with Mr King and was helpful. She was grateful to Mr Allsopp for volunteering to look at the technical aspects of the work of Monetary Analysis. The Governor said the questions for discussion were whether the right aspects had been identified and whether the Bank had proposed the right timetable.

Sir David Lees said that it was an excellent and helpful paper. He noted the reference on page 4 to the basic procedures of the MPC and said that it would be very helpful to have a write up of what the procedures were to give NedCo a clear picture. Turning to the bullet points on page 3, he said that it might be that the international aspect was missing. There was no reference to it though Court had spent quite a lot of time talking about the international dimension. Turning to bullet point 5, on the adequacy of resources, Sir David said there were two types of possible inadequacy of resources. One would concern what the Bank did not have in-house, which was a matter for Court and NedCo, which were responsible for making sure the MPC had adequate resources. There was also the question of external resources. Mr King, at the August Court, had talked about the under-resourcing of the ONS. Sir David said that NedCo, in its Annual Report, should not be afraid to reflect any external inadequacies.

Mrs Heaton, referring to page 3 of the paper, noted the point about setting out the procedures by which the MPC operates, and proposed that NedCo should formalise the processes by which it operated. She noted that the heading 'other information' in the MPC's terms of reference could be taken to include international work. NedCo was also responsible for asking what the MPC had not taken into account. In the passage of time, it would have to look back on whether the decisions taken

were right. She also asked whether the Non-Executive Directors should have a say in the timing of the release of minutes, because that was a procedural point.

The Governor said the whole world reviewed decisions of the MPC, and he had no objection to that. But this was not included in NedCo's terms of reference. The Act was very careful in its language to say that NedCo was not responsible for assessing the decisions but was responsible for process and procedures. Mrs Heaton agreed, but said there was an extent to which processes affected decisions. The Governor commented that the timing of the minutes was properly a decision for the MPC itself and there was nothing in the language that said otherwise, although the MPC did discuss the matter with Court before it took the decision. Mr Allsopp said NedCo was not involved in the decisions but was involved in the decision-making procedures. For example, when five years' data was available this might include looking at whether the stories in the Inflation Report looked sensible. Sir Colin Southgate said he was very concerned that a wedge was not driven between the Executive and Court, particularly as there were Executives on the MPC. He would like a lot of the discussions to be in full Court and if they were not he would be very worried. Mrs Heaton agreed. Sir Chips Keswick said he did not believe he had any statutory obligation to articulate hindsight.

Sir David Cooksey said it would be helpful to create a framework now for the sort of reports that NedCo would be producing next Spring. Dame Sheila noted that next month there would be a discussion in Court of the shape of the Report and it was necessary to see NedCo's report in the context of the Bank's Report. If there was a good explanation elsewhere in the report of the MPC's procedures, then the reference in NedCo's report may be a relatively small paragraph.

Mr Stretton said that his question after visiting the pre-MPC meeting was whether the foundations for the process bore the weight of what was put on top of it. At some point it would be necessary to look at the whole edifice and ask whether it stood on its foundations. But that could not all be done in Year 1. The Governor agreed and said that the process had to be evolutionary.

Mr Morris commented that it would be a mistake during a discussion of procedures and processes not to be very concerned about the impact the outcomes have on the outside world. In previous discussions, the degree of transparency had been touched upon. In recent days a whole range of people had been expressing interest in the outcome. He was not sure whether the review had a point

to make about that, but it had to be a process that was transparent and it came back to whether there was confidence in the system and in the structure. There was an immediate impact on the lives of millions.

Mr Hawker said that the quickest way to find out something was to ask, and it was necessary to ask the MPC whether it was getting the information required to do the job. It was very difficult to judge without asking that basic question. Dame Sheila said she had been struck by the difficulty that experts had in interpreting the data. She linked that to the quality of the ONS data. She said that a key question was whether any of the decisions would have been different if the information the MPC received reflected more accurately the real economy. That was the criticism, that the MPC was out of touch with the real economy. The link must be the quality of the data.

Mr Allsopp disagreed. He said it was true that the public view would be that the reason the MPC put up rates was that it hated industry and did not know what was going on. The fact was that all the members did know what was going on, and he did not believe there was a problem of ignorance of what was happening in the regions and in particular sectors. The problem was actually knowing the difficulties of regions and sectors and having to ignore them. Anybody who had been to a pre-MPC meeting did not feel a lack of information. There had not been enough on the international side, though perhaps that had changed now. But his worry was that the debate would move away to what the MPC was doing, how it made its forecast, and the operation of the models. That was harder to do. It was something that he was involved with professionally. It was not a question just of the quality of statistics, but was more complicated, because it concerned both the quality and the appropriateness. The simple question was whether inflation was taken into account. The harder part was, for example, what the MPC thought caused inflation, or what it thought about the natural rate of unemployment. The Governor said that he was sympathetic to the point, though it was still nice to have a crystal ball.

Professor Buiter said he agreed that the MPC was in touch. While not agreeing that it would have made a difference, Professor Buiter said he would have been a lot happier if the MPC had had earnings data that meant something, even before it discovered that somebody had divided by the wrong number. Sir Alan Budd said there had been occasions in the past where one of the explanations given for policy decisions was bad data, for example during the Lawson boom. It was

possible to be misled by inadequate data. The Governor said he accepted the international point made by Mr Allsopp. He suggested that the debate be suspended until Court returned to the discussions, as outlined in the timetable. Dame Sheila Masters said it was desirable to ensure that all MPC members joined Court when these issues were being discussed. The Governor said that that was a matter for NedCo. The Governor agreed with a suggestion from Mr Davies that it might be helpful for NedCo to look at international comparisons of procedures.

FINANCIAL STABILITY ISSUES

Developments in international markets (Messrs Clark, Vickers and Plenderleith together with Dr Julius, Professor Buiter and Sir Alan Budd in attendance)

Before inviting Mr Clark to open the discussion on international developments, the Governor reported that Mr Clark had been invited to join the board of CRESTCO. This followed from the recent decision to merge the operations of CGO, CMO and CRESTCO.

Mr Clark, turning to recent developments in international matters, said the news from emerging market countries had been slightly better in recent weeks, in particular with regard to spreads on borrowing. Among those that were relatively successful in their recovery programmes, particularly Korea and Thailand, the spreads had come down quite significantly, but there were exceptions. Russia and one or two East Asian countries were still poor credit risks. Turning to Brazil, Mr Clark said that there had been a lot of discussion at the Fund and the US Treasury about a programme. Brazil was still suffering an underlying outflow of $200-$300mn a day. In the recent past there had been some offset from privatisation and the net outflow had been reduced, but it was continuing, and much of that was portfolio adjustment by domestic residents, not withdrawal of funds by overseas residents.

The key was the package expected in a week or 10 days. Round 2 of the election was a week on Sunday and the intent was to have the package before that, if possible. Two key elements of the package were fiscal policy and exchange rates. Brazil was resisting a step change but recognised that it needed a significant real depreciation in the Real. How that was achieved would be one of the most important features of the programme.

Turning to Japan, Mr Clark said that until a few days ago there was not much sign of advance. However, there had apparently been a policy shift which would allow support for the banking sector to come into effect, and the quantity of support might also increase. Mr King reported on the meetings in Washington, which he said were not a tremendous success based on what appeared to be coming out in public. But behind the scenes a great deal more was agreed in substance. It was agreed that there had to be a package for Brazil, there was concern about the international situation and he noted the discussions of the G22, which over the weekend became the G26. This latter increase in number illustrated some of the concerns in Washington about procedures.

Once away from questions of procedure, there was quite a lot of agreement on method. He noted papers were published on strengthening financial systems, dealing with crises and improving transparency. The latter paper attracted support of a more concrete kind. On the face of it, the meeting was not encouraging, and the news from Japan was depressing. But looking back, steps had actually been taken.

Mr King commented that the way the meeting was handled, particularly by the US, left a great deal to be desired. His abiding memory was of a 1½ hour wait by Governors and Ministers for President Clinton to arrive for a TV appearance at the start of the G22/26 meeting. This was the moment that Congress was discussing impeachment.

In response to a question by Mr Allsopp about whether the Japanese package was real, Mr Clark said the Government had moved closer to opposition views, and the LDP had secured the support of minor religious parties, so there was certainly a change. In response to a question from Sir Chips Keswick about whether the ECB would have money to give to the IMF, the Governor said that it would be restricted to national contributions.

Commenting on the co-operation between the public and private sectors, Mr Buxton said that the private sector was awaiting developments, and the running had to be made by the IMF, which was not really making things happen. Mr Davies agreed with Mr Clark's summary. He commented that while the position with regard to the Japan package might look optimistic, at the same time Japan had produced figures showing capital ratios for banks consistently above 8%, using creative

accounting. In fact, some were below 4% in the way, using FSA methods. Until there was some honest acknowledgement of the position and the political will to deal with it, it was difficult to say that the problem was on the way to a solution. The authorities were still in denial about the scale.

The Governor commented that the IMF weekend was dispiriting, because of a reluctance to address the immediate issues of Brazil, Japan and Congressional approval of IMF quotas and the NAB. Even as little as a week later there was some movement on Japan, some sign that the US may vote the money for the IMF and a clearer understanding of the importance of Brazil. He noted that the discussion had caused people to focus on the issues in the aftermath of Washington. His view was that the situation was better now than a week ago.

FINANCIAL MARKET OPERATIONS

Open Market Operations:- Eligible Securities (Mr Plenderleith in attendance)

Mr Plenderleith reported that in its open market operations in the sterling money markets, the Bank proposed to extend the range of securities it would accept in its daily repo operations to include bonds denominated in sterling or euro issued by EU governments and major international institutions. This was to foster the smooth conduct of the Bank's operations. It would also mean that the Bank's operations and those of its counterparties developed in parallel with the euro area.

For operational reasons, the Bank proposed to implement these changes in phases. Mr Plenderleith noted that the change would help the Bank keep in parallel with the range of securities in which the ECB would be operating, but the main objective was to secure the effectiveness of the Bank's operations. The Governor noted that the change may give added liquidity to some of the markets whose instruments the Bank would take. It was not the primary purpose, but it would be helpful.

Management of the Bank

Quarterly Financial Report (Messrs Midgley, Clark, Plenderleith and Vickers in attendance)

Mr Midgley noted that all Sir David Lees' suggestions on presentation had been adopted. He also noted that the figures had been affected by the timing of projects. Finally he noted that in the projects report on Open Link, there was a red signal on timing and amber on quality. The amber, in fact, really reflected timing rather than quality.

Sir David Lees praised the Quarterly Financial Report and Dame Sheila Masters said it was an enormous improvement on anything Court had had in the past. Sir Colin Southgate asked why the Bank had not budgeted the full litigation cost of BCCI. Mr Midgley said that some of it had been budgeted but the outcome was bigger. Commenting on the red traffic light for the Open Link system, Mr Plenderleith said he was reasonably confident that the project would be in operation during the next week. It would be a tremendous step forward in the monitoring of the Bank's risk. Commenting on the amber traffic light, which had previously been green, Mr Plenderleith said he thought that light should in fact be golden. It was one of the most difficult projects his area had ever undertaken. It linked the RTGS to TARGET. So far it was working perfectly and was a tremendous achievement.

Registrar's Department Report (Messrs Plenderleith and Sparkes in attendance)

Mr Plenderleith said the Registrar's operation had undergone tremendous change in the previous 18 months, having obtained Treasury agreement that it should retain the work for five years. It had achieved a radical reduction in costs. The other half of the story was that Registrar's had continued to press down on the cost basis while delivering the required quality.

Mr Sparkes said that Registrar's had been successful in achieving the targets put before Court. This had to continue over the remainder of the five years. To do that, Registrar's had to continue to take cost effective measures. The target was not index-linked, and had a built-in productivity saving year-on-year as a result. With the volume of work still falling Registrar's would have to look at how

to achieve this while maintaining a quality service. He noted that on the timeliness target in particular, the majority of the work was now turned round within 36 hours against the previous level of more than 10 days. As a result of the tremendous change in personnel and support IT, there had been a slight increase in error and risk. That appeared immediately after the changes, but was back under control. Registrar's was receiving a considerable number of compliments as well as the complaints that were always received in a Department of this kind. Job satisfaction had increased to the point that there was hardly any staff wastage and work processes had been reviewed with the result that controls and checks which had been in the system for a long time had been changed. Audit controls and checks had been reviewed and Mr Sparkes said he was satisfied that Registrar's was not taking unnecessary risks to achieve its target. The introduction of IT systems to support the work had gone remarkably smoothly. He also noted the link to CGOII in London, and said that the trading position had been reconciled satisfactorily every night. Mr Sparkes also said that when it was realised that the whole of the freehold of the building in Gloucester could not be sold in one lot and was likely to be let floor by floor it had been decided to stay as a tenant in Southgate House. Refurbishment of the ground floor would be completed by Easter and so Registrar's was not now moving. Mr Sparkes also drew attention to comments in the Registrar's Report on a number of other projects including the integration of the National Savings Stock Register.

Dame Sheila Masters said it was a terrific achievement. Looking forward to the end of the five year Treasury agreement, she said there was no guarantee past that and she wondered whether there would be a challenge from competitors. She also noted that there had been more errors, but they were back on track. The Audit Committee had looked at how risks were managed in the new world.

Mr Sparkes noted that Audit were with Registrar's that week. Looking forward to 2002/3, Mr Sparkes said that the realistic approach was to live within the targets in the hope of striking a new contract with the Treasury at that time. He noted that independent consultants had tried to compare Registrar's costs with others but all they could find was the charges made for the work, because there was so much cross-subsidy. The consultants had given up. The future had to be to remain as competitive as possible in the hope of the Registrar's function remaining with the Bank. If it was necessary to go to market tests, then Registrar's would do so. Mr Sparkes agreed with Dame Sheila that the Treasury would benchmark on price not on cost.

Mr Bailie called it an excellent result and asked whether the Bank intended running this approach through other business units. Mr Plenderleith said it was certainly used across other banking and markets activities where it was necessary to demonstrate competitiveness and cut the cost base. Mr Bailie said what he meant was referring to a fundamental challenging of procedures and processes across all departments. Mr Plenderleith said that that was what the Bank had been doing in its banking operations. Mr Buxton commented that Registrar's had done well to get costs down so far. This was the sort of business that should be challenged year-by-year to reduce costs, which should be indexed downwards each year. His own company's costs per account were just over £3 for equities, and he did not believe that was subsidised. Mr Plenderleith agreed that the Bank wished to see a reduction each year but it was important not to create uncertainty about what would happen after five years, and it was too early to raise this issue. The Governor commented, following a recent visit to Registrar's, on how realistic he had found the Department to be. Sir David Cooksey noted the importance of benchmarking quality and that was where he believed the Bank had a considerable advantage. The Governor agreed that there was a quality premium. In reply to a question from Dame Sheila about whether there was a cross-subsidy from the Bank on redundancy and pension costs, Mr Sparkes said all the redundancy costs were within the project cost and the on-going operation of the Department was not subsidised.

Mr Davies said it was a very creditable outcome which would come as a great disappointment to the Treasury, which did not think it was possible to achieve it. The business would have to focus on costs of delivery. When he had been responsible for Registrar's, there had been an attempt to see if partnerships were available. The industry was restructuring, and the cost structures prevented any partnership arrangements. If the new results could be delivered consistently, in 2-3 years time there would be other options that could be looked at. Perhaps the question could come back to Court in 2-3 years.

In reply to a question from Mr Stretton, Mr Sparkes said he was happy with the staff he had, but an issue mentioned in the Report was the tremendous loss of experience suffered over the previous 18 months. There were people at Registrar's who had the potential to form a succession at senior levels. They were learning to operate without management overheads and with greater responsibility. The present staff were selected because of their ability to accept and handle change

and be fast learners. The Governor thanked Mr Sparkes and said Court appreciated what he was doing and recognised the challenges he had ahead.

Staff Pension Fund – Corporate Trustee

Mr Clementi reported a proposal to replace individual member Trustees of the Staff Pension Fund with a corporate Trustee which would be formed as a subsidiary of the Bank – BE Pension Fund Trustees Ltd. It was also proposed that the current Trustees of the Fund should become Directors of the subsidiary.

He drew attention to a Governor's recommendation in Court folders.

Court approved 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:-

1 the following should become Directors of BE Pension Fund Trustees Limited:-

Mrs F A Heaton (Chairman)
Mr James Stretton
Mr William Morris
Mr T A Clark
Ms M V Lowther
Mr J B Bixby
Ms R P Denney
Mr A N Piper
Mr A V J Ross

and that

2 Mrs Heaton or failing her Mr Stretton or failing him Mr Morris or failing him Mr Clark or failing him Ms Lowther or failing her Mr Bixby or failing him Ms Denney or failing her Mr Piper or failing him Mr Ross act as the representative of the Governor and Company of the Bank of England at any meeting of BE Pension Fund Trustees Limited.

Court also approved that the two shares in issue in BE Pension Fund Trustees Limited be held as follows:-

A one share in the name of the Governor and Company of the Bank of England; and

B one share in the name of Mr P D Rodgers, the Secretary of the Bank, as nominee of the Governor and Company of the Bank of England.

Court was content.

Executive Report

The Governor drew attention to two items under this month's Executive Report.

Outstanding litigation matters (Mr Berkowitz in attendance)

The Governor drew attention to a note from Mr Berkowitz which had been circulated to Court Members the previous week. It related to litigation matters arising out of supervisory functions which had been transferred to the Financial Services Authority with effect from 1 June 1998. Whilst the Bank was liable for damages in respect of action or omissions in the discharge of those functions before 1 June 1998, the FSA would be liable in respect of acts or omissions after that date. The paper referred to three claims in progress against the Bank; namely, BCCI, Lord Spens, and Bradford Investments.

Sir David Lees commented that if the claim from Price Waterhouse in the matter of BCCI did become active the Bank would be faced with a difficult situation. This was a point that had to be borne in mind in the unlikely event that an action materialised. Mr Berkowitz said that Coopers would be the Bank's expert witness if there were litigation and he believed they would be disqualified. However the risks of Price Waterhouse/Bank litigation had largely disappeared as a

result of the Price Waterhouse settlement with the liquidators. The Bank was in the process of establishing that formally.

Signing documents on behalf of the Governor and Company of the Bank

The Governor reminded Members that at Court last June, following the introduction of the new legislation, Court gave consent for the adoption of a new, streamlined process concerning the authorisation and application of the Bank's seal to documents. This related to sealing documents which Freshfields, the Bank's legal advisers, had vetted and confirmed were in a fit and proper form.

He added that three to four times a year, other documents were submitted by certain departments in the Bank to Peter Rodgers, in his capacity as Secretary of the Bank, for him, his deputy or the Assistant Secretary to sign on behalf of the Governor and Company of the Bank of England. Freshfields and the legal advisers representing the counterparty to such contracts, determined whether the documents needed to be signed or sealed. Those to be signed were also accompanied by a letter confirming that the documents were in a 'fit and proper form'. These documents tended to be fairly low key – such as contracts where the Bank, as landlord, granted a licence to alter or underlet premises to a tenant. The Governor reported that, under present practice, he gave the Secretary authority to sign these documents.

It was the Bank's understanding that, in commercial companies, signing duties of this nature were carried out by the company secretary, following board approval and it therefore seemed appropriate for Court to give its consent in this matter. The Governor pointed out that the Secretary, in signing on behalf of the Bank, was not authorising the contract; that had been done at an earlier stage usually by an Executive or Deputy Director under signing authorities granted to meet the Bank's normal business needs.

Court gave its approval for the Secretary, his deputy or the Assistant Secretary to sign documents on behalf of the Governor and Company in circumstances similar to those the Governor had described.

Indemnities for Court Members

The Governor reported that the question had arisen in recent months as to why Members of Court had not been specifically indemnified from liability by the Bank whereas in the private sector, this practice seemed to be commonplace.

Having discussed with his colleagues in the Bank how best to give Members the degree of comfort an indemnity could provide, he thought it would be appropriate that he should make a statement to Court outlining the nature of the indemnity and this would be recorded, formally, in Court's Minutes.

In this respect, he assured Court that it was the Bank's policy that each Member of Court be indemnified by the Bank against all costs, charges, losses, expenses and liabilities incurred by him or her in carrying out or purporting to carry out any of his or her Bank functions, or otherwise in connection with or in relation to such functions, provided that he or she had acted honestly, reasonably, in good faith and without negligence.

The Governor and Deputy Governors left Court and the meeting of the Non-Executive Directors' Committee commenced.

Sheila V Masters

Peter Rodgers

18 November 1998

A COURT OF DIRECTORS AT THE BANK

WEDNESDAY 18 NOVEMBER 1998

Present:

Mr George, Governor

Mr Clementi, Deputy Governor - Financial Stability

Mr King, Deputy Governor - Monetary Stability

Dame Sheila Masters, Chairman, Sub-Committee of Directors

Mr Allsopp

Mr Bailie

Mr Buxton

Sir David Cooksey

Mrs Heaton

Sir Chips Keswick

Sir David Lees

Ms McKechnie

Mr Morris

Mr Neill

Sir Neville Simms

Sir Colin Southgate

Mr Stretton

The Minutes of Court of 13 October were amended and approved.

MONETARY DISCUSSION

The Inflation Report, together with the economic and monetary discussion, incorporating the monthly MPC Report to Court (Messrs Vickers, Plenderleith, Hatch and Professor Buiter in attendance)

Mr Vickers drew Court's attention to the Inflation Report, the November MPC minutes and the fifty basis point cut in interest rates at the beginning of the month. He said there were two main areas of economic news since August affecting the Inflation Report. The first was

international - the Russian situation had been developing from mid-August, capital controls were introduced in Malaysia and there was a deepening weakness in Japan, which had major implications for trade flows and financial markets of all kinds.

Second, in the domestic economy, the official data contrasted with survey data and with information from regional agents. However the September industrial production figures were more in-line with the gloomier survey data. The Inflation Report projections for growth showed a year-on-year dip to below 1% in 1999 before returning to about trend rates in the second half of 2000. The central projection was not a recession but there was a distinct possibility of between one in four and one in five that one would occur in any quarter in 1999. In comparison with the Treasury, the forecast looked quite similar, though the Bank's was at constant interest rates and the Treasury assumed a reduction in rates. The MPC thought the risks were mainly on the downside so its average outcome, the mean, was a bit less than the central forecast.

Inflation on the RPIX measure was broadly on target in the central projection, but there was a possibility of a pick-up early next year, mainly because of developments in the labour market, though there was great uncertainty about that. The report stressed that there were particularly large uncertainties about the inflation profile at the moment. The uncertainty was heightened by the average earnings index fiasco. There were no new data on the AEI but a very different and very confusing picture had been produced. Mr Vickers drew attention to Chart 3.2 on page 24 of the Inflation Report, and commented that the new presentation of the earnings figures was at odds with other pay data such as settlements. He noted that the average earnings index had been suspended and an enquiry was being led by Mr King and Sir Andrew Turnbull, working with Martin Weale of the National Institute for Economic and Social Research. The paper promised for Court on earnings would be delayed. Mr Vickers noted the employment data published on 11 November included an increase in unemployment on the claimant count, but he commented that the true increase may have been smaller, and was possibly negative.

Mr Vickers said that there were two MPC themes. One was symmetry: if there was upward pressure on inflation the MPC's job was to bear down on it, but if it were heading below target the job was to bring inflation back up. The second point was that the task was forward looking.

Mr Vickers noted the recent inflation data and said that RPIX had been at 2.5% or 2.6% for seven of the previous ten months, a proximity to the target which he thought almost freakish. He noted very benign goods price inflation, and also drew Court's attention to retail sales volumes and to the British Retail Consortium and CBI surveys.

Mr Vickers noted a restructuring in the Monetary Analysis area of the Bank and drew Court's attention to a number of changes of personnel at Head of Division levels. He said that a division would be established within Monetary Analysis for International Economic Analysis under Andrew Bailey. The division would cover economic developments in the major industrialised economies and in the world economy in so far as it impacted on UK monetary policy. It would include the Bank's economic analysis of EMU related issues. There would not be a sixth division in Monetary Analysis because the Inflation Report team of economists would go to their respective divisions. Responsibility for drawing together the Inflation Report would be given to the new Deputy Director of Monetary Analysis, Nigel Jenkinson.

Mr Plenderleith said that the distinguishing feature of the markets had been the dogs that had not barked. There had been a good deal less volume and markets had been somewhat steadier. Central banks had been lowering interest rates, which had fallen 0.75% in the UK and the US. Capital markets were also somewhat steadier after the August and September upheavals, but there was still evidence of considerable aversion to risk, and there was still fragility in the markets. They were vulnerable to future bad news or shocks.

Mr Neill said that in the first ten days of November the car market had risen 1% with the retail side falling 2.6%. Car manufacturers were cutting back on production, as he had suggested some months before would happen. Imports were about 68% of sales, compared with about 50% a few years ago. The industry predicted 69% next year. The forecast for next year was for a fall of about 7% on this year, and for a further fall in 2000. Prices of nearly new and used cars continued to be depressed.

Mr Buxton said that bad debt levels were rising very slowly, but there was nothing dramatic. Everyone was, however, wondering how far it would go. His bank had been predicting a slowdown, and could now see that slowdown.

Sir Neville Simms noted that there was still a lot of construction activity, but inquiry levels were dropping back, and order books contained many more projects where there were worries that they may not in the end go ahead. Faster construction periods also implied that, when the tap was turned off, the industry was hit very much faster. Labour costs were affected by the degree to which the industry had lost skills in the previous downturn and was now short of them, by tax changes which put up wage demands and by the working time directive which would cost 2-3% of the wage bill. In the housing market there was a discernible slowdown. In the West Midlands, construction was quite strong, along with London and the South East but there were a lot of projects being discussed which he did not believe would happen at the end of the day. The slowdown was expected to accelerate quite rapidly in the second half of 1999.

Mr Morris said that at the last Court it had been noted that manufacturing was slowing but services were pretty robust. He asked whether there had been any visible change both in this picture and in productivity trends.

Sir David Lees noted that he had had a meeting in Paris the previous Sunday with the European Round Table, representing 45 of the largest businesses in Continental Europe. There was a feeling that growth on the Continent might be rather less exciting than was expected a few months previously, and there was concern at political changes that might have an impact on business prosperity and growth. He agreed with Mr Buxton that in the UK there was a slowdown, but it was very difficult to be precise as to the shape of the curve.

Mr Bailie said that the main difference was that in August and September the debate had been about hard versus soft landings and now the talk was about battening down the hatches for a recession. Industrial confidence was a lot less than it was and that was going to feed into delays in investment.

Mrs Heaton said she had been to the United States recently and was amazed at how much more confidence there was there. Mr Allsopp asked whether confidence in the United States was misplaced.

Responding to the previous points, Mr Vickers said that in services truly desegregated official data was not available, and most of the clues to what was happening came from surveys. These indicated a significant weakening from a strong position. The third quarter British

Chambers of Commerce survey showed that employment intentions and services were reasonably buoyant, but nothing like the level three months before, while in manufacturing there was a sharp downturn. The CBI distributive trades survey had been successively gloomier for several months and there was a very sharp downturn in the CBI survey of the financial sector.

Turning to productivity, he noted the recent revision in the national accounts, which he said did not change the recent growth pattern very much. But the level of GDP had been revised up by about 2% cumulatively since the early 1990's, which implied higher productivity, though there were a number of caveats in the figures.

Turning to the US, Mr Vickers said that if the equity market was a guide there had been a remarkable rebound, only just shy of the peak in the summer. There may have been confidence boosting effects from the three rate cuts, but he found it a very difficult question to judge.

Mr Morris, commenting on Sir Neville Simms' point about the working time directive, said he was not sure that an increase of 3% was generally the case, particularly since the construction industry was leading the debate on derogation. Sir Neville Simms said it was a Tarmac view as much as an industry view. Mr Vickers said that some of the Agents had raised the working time directive as quite an important issue and this was covered on page 30 of the Inflation Report. The Department of Trade and Industry's upper estimate was half a percent which looked quite high. The Bank would be more in-line with Mr Morris but it did not have a very firm view. The impact of the working time directive was not in the Inflation Report's central projection but was considered as an upside risk. If it were half a percent it would be of the same order as the national minimum wage. Mr Vickers said the Bank would be very interested in anything Sir Neville Simms could provide. Sir Neville Simms said he would put a paper to the Bank.

EXECUTIVE REPORT

Composition of Earnings Data

The Governor said an enquiry into the earnings data had been announced, and it was it hoped to have some results before the MPC meeting on 9 December. The next scheduled date for the

earnings data was on 16 December. The paper on the composition of the earnings data had been withdrawn but, when the Bank had the results of the enquiry, it would report back to Court.

Bank Agency in Northern Ireland

The Governor noted that the Bank's coverage of Northern Ireland was from Liverpool. When he visited Northern Ireland he was struck by the fact that the situation was very different, particularly in the context of monetary union and the relationship between the North and South of Ireland. The Bank therefore wished to establish an agency in Northern Ireland. The advice from the security people was that there was no obstacle to that. The Bank would, with Court's agreement, move to trying to identify a candidate first from the staff and possibly outside. It would be a small agency with an Agent and perhaps one or two support staff. The plans would be discussed with Mr Bailie. Mr Bailie said he was delighted.

Court APPROVED the proposal.

Mr King – A Commitment

The Governor reported that Mr King had been invited to take up the honorary position of President of the Institute for Fiscal Studies for a period of three years with effect from May next year. The main duty was to chair the annual meeting. The Governor commented that he could not see any conflict or difficulty with that.

MANAGEMENT OF THE BANK I

A Report from the Chairman of the Audit Committee

Sir David Lees drew Court's attention to the draft minutes of the last Audit Committee in folders. He noted that the Committee was addressing the question of the speed with which NMB and Minories Finance could be rundown. He noted that on page 4 there was a reference to the National Audit Office, an on-going situation. The Office appeared to be keen to be more

closely involved in the Bank. On the whole, the Bank had been reasonably successful in resisting this. It was an issue that the Deputy Governor, Mr Clementi, kept under review.

He noted also that there had been a very full presentation on two key systems issues for the Bank, Monetary Union and the Year 2000. The Committee felt that the Bank was addressing these two issues with very considerable efficiency, with Mr Clementi and Mr Plenderleith leading from the front on these important matters. There was no complacency, but the Committee had considerable confidence that the Bank would deliver on both. The presentations were excellent and the Audit Committee was generally comfortable.

He noted that on page 9 of the report, in response to a question from Mr Neill about audit fees and competition, there was a table of audit fees from 1994-1998, excluding NMB. The audit fees in 1994 were £172, 000 and in 1998 £175, 000. Sir David commented that he thought that these were being kept well under control.

Turning to paragraph six on the same page, he noted an exercise that Mr Clementi had described as a section 39 review on the Bank itself. This was an initiative which the Audit Committee was extremely enthusiastic about. Sir David also noted a series of agreed action points on the bottom of page 11, covering aspects of the PriceWaterhouseCoopers Report, which would be coming back to the Committee in the months ahead.

Finally, on page 12, he noted that the Audit Committee had had its annual bilateral consultation with the internal Auditor. During the private discussion the Auditor had given the Committee no particular concerns.

In response to a suggestion from Sir David Cooksey that the audit could be put out to tender, Sir David Lees said that he thought this would be a very nice subject for the next Chairman of the Audit Committee to tackle. The Governor noted that this was a point to which the Bank would return. He thanked members of the Audit Committee. He also commented that a comparison of the minutes of the Audit Committee with those produced as recently as five years ago showed that there had been a considerable advance in the governance of the Bank of England and he acknowledged the really hard work that went into the Audit Committee.

Commenting on preparations within the Bank for the Euro, Mr Plenderleith said most of the Bank's projects for operating in Euro were in place or very close to being so, and the focus of work was very much on the conversion weekend. More than 200 staff would be there for the critical 72 hours. A full-scale dress rehearsal was arranged for the coming weekend. If it did not go well there would be another the following weekend and every weekend afterwards until the Bank knew that it could do it. The most difficult area was the lack of clarity in the details available from the ECB on matters such as TARGET, but most of that was settled, though there were still some bits to sort out with the ECB.

The Governor reported that the TARGET discussion, which had been a difficult issue between the Bank and the ECB, was very close to a resolution. The issue was that, if liquidity was left in the system overnight, the ECB was going to require the balance to be remunerated at its deposit rate, which would be below market rates. Since €3bn was involved this would amount to a very considerable tax. The Governor noted that the ECB, subject to settling some details, had agreed that the Bank could move its liquidity into the ECB every morning and take it out and put it into the market every evening. It was a hassle, but it did allow the Bank to earn a realistic market rate on the deposit. With some reluctance the ECB had agreed that the Bank could operate that way. The Bank was in the process of raising €3bn and would then agree arrangements for the process with a number of counter-party banks.

Mr Buxton commented that it was a great step forward. There were a lot of benefits, particularly for smaller banks in the UK that did not have Continental subsidiaries. The Governor noted that if the arrangement had not been made the Bank would have had to pass the tax to the banks, which would have been a great discouragement to using TARGET. It would have led to greater use of multinational netting systems, where the risk was higher. In reply to a question from Mr Allsopp, the Governor said that for the first time a country had been given access to intra-day credit in another's currency and he noted that the ECB was making a concession to the Bank.

Ms McKechnie noted that last month there had been very much more positive noises from politicians about UK entry to Monetary Union. She asked whether the Bank was responsible for advising the Treasury on the time-scale for preparation by British banks. The Governor said that the Bank was one of the sources of advice for the changeover plan being prepared by Lord Simon in consultation with a number of interested bodies in industry and finance.

Mr Clementi said that the Year 2000 work was co-ordinated by Mr Norman. The only change he wished to report in management was that Mr Footman was becoming Project Director. Mr Clementi noted that preparations were pretty well advanced and the only slippage he saw was in Banking & Market Services, which was not a surprise to him. There would be a report back to the Audit Committee in March. He was confident that he would be able to demonstrate that the Bank was in good shape.

Dame Sheila Masters noted that the emphasis in industry had shifted to disaster recovery plans. Mr Clementi said that the Bank was looking at back-up supplies of energy, water etc and a lot of work was already being done on contingency planning. There were, however, some systems the Bank could not test. An example was perimeter security at the Printing Works. It was not possible to get an absolute assurance that it would not be affected so the Bank was arranging for extra security guards. In response to Ms McKechnie, who noted that the Consumers Association was already making arrangements to get personnel in for the Year 2000 weekend, Mr Clementi said the Bank had started to think about it and would possibly have to do more, but it was going to have a mini dress rehearsal this year over the Euro weekend.

FINANCIAL STABILITY ISSUES

Developments in international markets (Messrs Clark, Vickers and Plenderleith, together with Professor Buiter, in attendance)

Mr Clark noted that in emerging markets the key development was that spreads continued to ease and in a number of countries were back to the levels before the Russian crisis. Even where that was not true they were half or two-thirds of the way back.

A major development was the announcement of an IMF programme for Brazil totalling $41.5bn. A little less than half was from the IMF itself and $14.5bn was arranged bilaterally from a group of countries. The rest was from the multilateral development banks. He noted three reservations: essentially nothing had been done on the exchange rate and the Real would continue to crawl at a similar pace to the past; there was a question about capital flight, though the evidence was more positive since the figures had fallen from $300-$400mn a day to virtually nothing over the last few days. However there was nothing in the programme that

explicitly addressed short term out-flows. Finally, there was the related question over the restructuring of Brazilian debt. Brazil was still paying about 40% nominal on new borrowing which translated into something pretty close to that in real terms. This was an area of concern. He commented that it was important that the programme should work because, if it went off the rails, it would have a serious contagion affect in Latin America and would undermine the credibility of the IMF.

Turning to the G7 Communiqué, he noted the proposals for strengthening the international financial machinery. There would be a new liquidity facility to prevent contagion spreading; there was a proposal from the Chancellor for a new International Standing Committee to take steps to strengthen the international financial system; there were also further comments on private/public sector burden sharing, though Mr Clark believed there was still some way to go to find a satisfactory way of dealing with that.

The Governor commented that there had been considerable movement since the IMF meetings, which had taken place at the height of the nervousness about the situation. Japan had voted money to help with domestic demand, the adjustment of the exchange rate had helped to improve sentiment in Asia and no new hedge fund disaster had emerged. All this had been helpful. The improvement had been captured in the G7 Communiqué which Mr Brown had driven through - and all credit to him. It gave a sense that things were not as out of control as they had appeared to be at the IMF meeting. The skies were not blue but they were a bit less dark.

In response to a question from Sir Colin Southgate about whether Brazil had accepted the terms of the package, Mr Clark said that Brazil had done so in the sense that there was a letter of intent, but not all the measures had gone through parliament, so to that extent there was doubt about whether they would be implemented. However, he noted that the programme was very heavily front loaded, with around $25bn to be paid out within the first three months.

MANAGEMENT OF THE BANK II

Personnel Issues

With reference to a Minute of 16 September, Mr Clementi drew Court's attention to impending changes at Head of Division level, namely:-

1 Mr Andrew Bailey, currently the Governor's Private Secretary, would become Head of a new International Economic Analysis Division. The Division would cover economic developments in the major industrialised economies and in the world economy in so far as they impacted on UK monetary policy.

2 Mr Paul Fisher would take over as the Governor's Private Secretary.

3 Mr Neal Hatch would take over Mr Fisher's place as Head of Conjunctural Assessment and Projection Division.

4 Mr Ian Bond would take over from Mr Nigel Jenkinson as Head of Structural Economic Analysis Division. Mr Jenkinson's promotion to Deputy Director, Monetary Analysis, had been announced in September.

5 Mr Spencer Dale, currently Mr King's Private Secretary, would replace Mr Paul Tucker as Head of Monetary Assessment and Strategy Division. Mr Tucker's promotion to Deputy Director in the Financial Stability area had been announced in September.

6 Mr John Matheson would take over from Ms Merlyn Lowther as Head of Personnel Division reporting to the new Director of Personnel, Mr John Footman. Ms Lowther's promotion to Chief Cashier had been announced in September.

7 Mr David Pennington would take over from Mr Gerry Everett as Head of Property Services and Security Division as Mr Everett would be retiring.

Mr Pennington would take up his new post at the end of November; Messrs Bailey, Fisher and Hatch would take up their posts on 1 March 1999 and the other moves would take place on 1 January 1999.

Court NOTED the changes.

Report on the Senior Staff Conference (Messrs Plenderleith, Vickers, Clark, Footman, Midgley, Smout, Brierley, Fisher and Ms Lowther in attendance)

Mr Smout said it was the third annual Senior Conference for those at HoD level or above. The 1997 conference had focussed on strategic questions in the light of the events of May 1997, notably Bank independence and the loss of supervision. This year, by contrast, it looked more at management and implementation issues. For each subject, a working group under the chairmanship of a Deputy Director studied the issue over the summer and the relevant team gave a 30 minute presentation at the Conference itself. The 5 topics selected were those most favoured by HoDs: recruitment, training and development, international work, management information systems, and performance management and the annual report.

Mr Footman masterminded the last of these exercises, and would be briefing on this shortly. So far as the other subjects were concerned, the discussions highlighted a number of points, of which Mr Smout selected five: a need to review the recruitment process for non-graduate staff; proposals to rearrange the presentation of international work, while emphasising its cross-Bank nature; a clear appreciation that IT issues would become even more central to the Bank's work in the near future, not least as a means of more efficient communication; some interesting ideas on how to build on experience with job advertising; and finally a need for more effective implementation in some areas of training and development (in particular management training), but not at the expense of specialist skills.

So far as the process was concerned, Mr Smout said the experiment with the working groups was a great success, as was the chance for HoDs from different areas to work together and to discuss their shared problems. So the overall verdict was unquestionably positive. With hindsight it was possible rather too many subjects had been chosen, and next year it might be necessary to look at the number again. More generally, it was important that there was no set format for the Conference, and that it should have the flexibility to address current live issues.

For instance this year the Conference concentrated rightly on management questions after the focus on strategy in 1997, but it might not wish to do so every year. Finally, Mr Smout said a number of participants expressed the hope that next year the location might be more convenient than Weybridge.

In response to a question from Dame Sheila Masters about how the points made at the Staff Conference were followed up, Mr Smout said that some, such as those made on the international work, could be implemented straight away. On others, for example training and development, work was already under way in Personnel. Mr Brierley added that the working group on recruitment had been asked to continue its enquiries, and would be meeting regularly over the next few months.

Ms Lowther confirmed that among Personnel's tasks was the question of non-graduate recruitment. She said Court might remember proposals she had introduced for structured training and development. Alongside that, Personnel had identified recruitment as an issue. It had carried out a lot of work on job advertising. Personnel found it useful to expose its ideas to a senior management group at the conference – the customers – and had received a ringing endorsement, giving it more confidence in its plans to take the work forward.

Mr Morris said that he was delighted that recruitment and job advertising were key issues at the conference. Equal opportunities were not just an objective, but had to be demonstrated. He had not seen any real evidence that the Bank, in its staffing profile, looked like the whole of the UK. He noted that President Clinton had said on taking office that he wanted his Government to look like America. The Foreign Office had a very active programme of training and recruiting and recognised that it had to represent the rest of the UK. So did the Home Office and the Army. Mr Morris said he hoped that held good with other institutions. It was a general issue, not just a racial issue, and he was sure it was being addressed. He looked forward to hearing about job advertising, and noted that there was a whole range of newspapers addressing different communities. He said he would be taking a keen interest in the Bank's activities in this area in future.

The Governor noted that Ms Lowther was talking about internal job adverts, but said that Mr Morris' point was very well made. Mr Clark noted that he was chairman of a working group on the employment of ethnic minority staff. Local papers were used but the results were

not terribly encouraging. The Bank was constantly looking for new approaches, but the issue was on the radar.

In response to a question from Mr Neill about the number of staff attending the conference, Mr Fisher said there were 40-50 attendees. He noted that they had been briefing other staff on their return. In response to a question from Sir Colin Southgate on management training, Mr Smout said the message brought away from the conference was that there was a false antithesis of specialisation against management skills. There was perceived to be a need for more management training, but this was complementary to the specialised skills needed. Ms Lowther noted that what the Bank needed was more management learning rather than management training.

In response to a question from Ms McKechnie about how the Staff Conference fitted into the setting of objectives, the Governor said that the conference input last year was particularly linked to the strategic objective, whereas this year it was more into management process. However, Mr Clementi had taken account of some of the points from the conference for his objectives and strategy paper. Court would discuss and agree the objectives and strategy and then the results would be taken back down. It was an iterative process. The Governor said he would be unhappy if it emanated from the top and were fed down. The process was quite clear and had been established over a period.

In response to a question from Mr Buxton about information technology, Mr Fisher said the conference had identified that as an issue it needed to spend time on next year. Many Heads of Division felt they needed to run to keep up, and that it was necessary to devote more management time to IT across the Bank. Mr Stretton said that the issue was how much the Bank let IT developments generate themselves as organic improvements and how much the Bank went into research and development mode, thinking about how IT could be used to make things work differently. He asked whether this was being debated. Mr King replied that an example was the working party on information about financial markets. The working party was exploring how to pull together information already within the Bank. Part of the Intranet was being designed so there would be easy access to up to date information from the markets, to interpretations by Mr Plenderleith's team, to comments by Mr Vickers' team and to information in Mr Clark's area on financial infrastructure and overseas issues The Intranet would ensure that those with a particular interest would be able to click on their screens, and it

would be brought together. A working party was being set up now to design that aspect of the Intranet. The Governor confirmed that the question of the Bank's approach to IT was likely to be examined at next year's conference.

Measuring the Bank's performance, and the Annual Report (Messrs Plenderleith, Vickers, Clark, Footman, Midgley and Ms Lowther in attendance)

Introducing his paper, Mr Footman said there had been problems with existing arrangements. The Bank had published 14 high-level strategy objectives and 27 area strategic aims, which sometimes repeated the main strategic objectives. Separately, in the Budbook, there were 49 business objectives and a further set of 55 management objectives. It was inevitable that there were inconsistencies.

He commented that there was no clear process linking the formation of strategic aims to business areas and through to budgets, and then on to the uncharted territory of performance reviews in the framework of the new Act. He drew attention to an illustration of a "Route Map". This proposed that the three core purposes - reviewed by Court in November each year, but unlikely to vary much - should feed into the strategic objectives, which would be set by Court each November for the Bank as a whole. The strategic objectives would provide the emphasis for the year, and would also be the context in which area business aims and budgets would be formulated. The strategic objectives would be published in the Annual Report, and reviewed the following year. Area business aims, which would take account of the strategic objectives set by Court, would be included in the budget proposals to Court in February. The aims would include suggested performance indicators. Turning to the review process, Mr Footman said business areas would submit reports, initially to the Executive, showing performance against indicators, and these reports would form the basis for the Executives' report to Court. Court and NedCo would then review Bank performance against the strategic objectives, basing their review on the report from the Executive and also on supporting evidence from area performance reviews. This review would feed into the Annual Report, which would include an account by Court of the Bank's performance against its objectives and strategy, based on a discussion of the Executive's paper and a formal report from NedCo. Mr Footman noted that the core purposes represented the what, while the strategic objectives represented the how. Some objectives would operate in a continuing manner, and some would relate to a particular period, for example the Year 2000 work. Since key strategic objectives had to be set for the Bank as a whole, they had to be functional and would not be set for or

driven by particular divisions. He proposed that only the strategic objectives, not the area business aims, should be published.

However, for local areas of the Bank there would have to be provisions for review. As far as possible, business areas should identify what was deliverable – in other words the outcomes expected. For factory areas, there would be controls on spending; for projects, the outcome would be completion; for some more policy-oriented areas of the Bank, the indicators were more difficult to get at. Mr Footman drew Court's attention to Appendix 2 of his report, and noted that it may be necessary to fall back on asking the customers what they thought. For Monetary Analysis, that would mean asking the Monetary Policy Committee, and for Financial Stability a wider range of customers. The review would go back through the objective and strategy setting process in reverse, as described in the Route Map. He noted that the Executive, when reviewing the area material, would look at the Bank in terms of functions, as it would do at the equivalent stage of the objectives and strategy setting process.

Mr Footman said that the Bank of England Act 1998 referred to the setting of objectives and strategy. He believed there was a clue in the Act to which of these, in the language he was using, was an objective, and which was a strategy. This clue might be in the section dealing with Monetary Policy, which said that the objectives of the Bank of England were to maintain price stability and support the economic policy of the Government. Mr Footman commented that if that was what the Act thought of as an objective, objectives were therefore mostly contained in the core purposes. Strategy referred to the strategic objectives the Bank set for itself.

Dame Sheila Masters said that Mr Footman's work had been terrific. She was nevertheless still concerned about the definitions of strategy and objectives, and perhaps there should be a further dialogue with Mr Berkowitz. She also asked how the 1998/9 objectives and strategy would be reconstructed in a form suitable for Court and NedCo to review. Dame Sheila Masters, in response to an indication from the Governor that he was not sure what the dilemma was, said that she was questioning the proposal to make the objectives equivalent to the three core purposes and the strategic objectives equivalent to the strategy. She was not entirely confident about that equivalence. She noted that the Bank had more than one financial management objective. The key issue was what level of detail to enter, and what to measure against. It was necessary to use language which could be explained to Parliament in discussing

what Parliament had asked the Bank to do. Ms McKechnie noted the difference between outcomes for the Bank, which were the public interest matter, and the role of Court in overseeing the use of resources and financial management. Court would review the latter issues in more depth, but would say in the Annual Report simply that it had looked at efficiency and effectiveness and was satisfied, thus truncating huge sections of the old Annual Report.

The Governor said that everybody agreed on this point. The Route Map accorded with that. He asked Court whether it was in agreement with the Route Map. Ms McKechnie said the Route Map was absolutely fine but she noted the importance of reconciling the Act with Mr Footman's point about reducing the level of detail.

Mr Footman said the Bank could say it had set its objectives and strategy in terms of Section 2 of the Bank of England Act. Mr Berkowitz advised that reasonableness was the test. The question was whether it could reasonably be said that in setting the core purposes the words of the Bank of England Act had been used.

Mr Morris commented that the core purposes, which were in essence constant, were not a major issue. For him, what was missing was an extended dialogue before getting to the review. The Directors should have the opportunity to have a free-flowing discussion of some of the variances of the year before. This should precede the November review. He did not believe it was possible to have that sort of discussion and interchange of ideas and to develop a robust idea of the process at the end of a routine Court meeting. Next time round, Court should set aside time for this before the November review. Senior staff had had the opportunity to look backwards and forwards, but Court had not.

The Governor said it was necessary to set aside away time, not as part of Court, but as part of the process. If Court saw significant issues which affected the strategic objectives, finalising the objectives could be delayed to the December meeting.

Sir David Lees said it was important to get absolutely clear what the words in the Act meant and how the Bank read them. It was not very clear at this point and he hoped that it could be clarified with Mr Berkowitz's assistance. Mrs Heaton noted the importance of the reasonableness test. The Governor commented that what the Bank would set was what

Mr Footman called the strategic objectives, provided Mr Berkowitz said that they were consistent with the Act. Sir Colin Southgate said it was necessary to check that the Treasury agreed with the Bank's interpretation. The Governor commented that he would be resistant to clearing strategic objectives with the Treasury. But he would be happy to inform the Treasury that the Bank was setting strategic objectives, as interpreted by Mr Footman. Mr Berkowitz could confirm that the interpretation was consistent with the Act and the Bank could then explain to the Treasury what it was proposing to do. Dame Sheila said a brief paper to Court was needed, explaining what was being done and including Mr Berkowitz's comments that it was consistent with the Act. The Governor agreed.

Mr Bailie asked how it would be known whether area review targets were hard or soft. It seemed to him that the targets were being set by the staff. The Governor replied that the real question was how to provide hard targets. It was in the nature of the business that the Bank had to do the best it could. Sir David Lees commented that the precise wording of the ten objectives had to be very carefully selected. Words such as deepen meant all things to all men. Objectives should not be written unless it was possible to answer the question how they were going to be measured in twelve months time.

1999 Bank Strategy (Messrs Plenderleith, Vickers, Clark, Footman, Midgley and Ms Lowther in attendance)

The Governor said that this was an appropriate point at which to look at the objectives. Dame Sheila congratulated Mr Clementi on a wonderful paper. She wondered, however, whether there was a problem with objectives 9 and 10 in that they themselves applied to objectives 1-8. Number 9 read: *To manage the Bank's resources efficiently and transparently, achieving reductions in central overheads consistent with the Bank's functions following the 1998 Act, and delivering an appropriate return to the shareholder.* Number 10 read: *To review the management of the Bank's balance sheet and to implement a new framework for monitoring and controlling financial and operational risks.*

Numbers 1-8 could be looked at in terms of the Route Map. But she suggested that Mr Clementi should come back on 9 and 10 in a more detailed way, looking at the broad issues of where the money was going and whether it was spent in a value for money way. It was Court's job, as a matter for internal management, not for the external world.

Mr Clementi said that he would look carefully at objectives 9 and 10. He could envisage that 9 was an eternal objective and 10 might change. Mr Plenderleith suggested that number 10 was like numbers 1-8, in that it referred to two specific tasks. The Governor agreed that number 9 was different because it was a process. The budget was presented to Court and Court monitored it quarter by quarter. Mr Neill commented that number 9 was central, not peripheral. Sir Colin Southgate said it propped up numbers 1-8.

Mr Stretton said that strategy was about making choices. The paper included a number of things that were business as usual, but which the Bank was aiming to do slightly better. But there were four things that were different: EMU, Year2000, building public support for the Monetary Policy Committee and objective 10, which was a result of a decision to do something on risk management. So the objectives were a mixture of business as usual and a number of projects which Court thought were important. He also said that the Bank faced two quite different futures, in or out of EMU. Scenarios would help in terms of deciding where to spend money intelligently. The Governor said that Court could take this when it came back to the objectives in December.

Mr Bailie suggested that objectives 9 and 10 could become objectives 1 and 2. Mr Clementi said he was not sure he agreed because the Bank was not set up simply to run itself efficiently, but to carry out some core purposes and alongside that to run itself efficiently. To start with objectives 9 and 10 would give the wrong flavour. The Governor said there was a dilemma. It was very easy to say the objectives should be measurable. But the Bank needed suggestions from Members of Court as to how it could make measurements. It was in the nature of these things that it was possible to measure input but not output. Some elements could however be measured. For example, the Bank was considering opinion polls on whether it was building public support for price stability.

Sir David Lees noted that objective 7 contained both a particular objective and a high level objective, both related to Year 2000 work. Mrs Heaton said it was wrong to say that there could not be objectives because they were not measurable. The Governor commented that measurability could be achieved, in that sense, in the area of business aims. But the objectives had first to be set. Sir David Lees said that he agreed with this - that the objectives would be measurable through sub-sets. Sir Neville Simms said he supported this. Performance

indicators were built in further down. He agreed with Mr Stretton's point that there was a mixture of elements in the paper, and said some further ordering would be helpful. The Governor asked all Members of Court to write in with comments. He would particularly welcome written comments or thoughts on the strategic objectives set out in the report for next year. The paper would be brought back for the next Court.

The Governor said he took it from the discussion that there was general support by Court for the Route Map. Court agreed.

Governor's engagements

The Governor reported the death of Sir Robin Brook on 24 October. He had been a Non-Executive Director from 1946-49 and at the time was the youngest ever NED. The Governor said he had written expressing condolences to his family on behalf of the Bank.

Sheila Neal

Peter Rodgers

18 November 1998

A COURT OF DIRECTORS AT THE BANK

WEDNESDAY 16 DECEMBER 1998

Present:

Mr George, Governor

Mr Clementi, Deputy Governor - Financial Stability

Mr King, Deputy Governor - Monetary Stability

Dame Sheila Masters, Chairman, Sub-Committee of Directors

Mr Allsopp

Mr Bailie

Mr Buxton

Sir David Cooksey

Mr Davies

Mrs Heaton

Sir Chips Keswick

Sir David Lees

Ms McKechnie

Mr Neill

Sir Neville Simms

Sir Colin Southgate

The Minutes of the Court of 18 November, having been circulated, were approved.

MONETARY STABILITY ISSUES

Economic and Monetary discussion, incorporating the monthly MPC Report to Court (Messrs Vickers and Plenderleith together with Professor Buiter and Sir Alan Budd in attendance)

The Governor said that the minutes of the meeting of the Monetary Policy Committee held the previous week would not be published until 23 December but he felt that their absence should not limit the discussion.

Mr Vickers noted that rates were cut by fifty basis points at the December meeting of the Monetary Policy Committee, to 6.25%. He drew Court's attention to the text of the press release and said that the prospect for global activity appeared to have weakened even though the United States had turned out to be stronger than expected, with some question marks over how long that would continue. In Japan, he noted continuing weakness while in Europe there were some signs of slowing activity. There had been a co-ordinated rate cut among the European Monetary Union countries on 3 December, almost all of which went to 3%. There were some worries about emerging markets: in Brazil the IMF package had been announced, but interest rates were still very high. Another emerging market worry related to the oil price which was the most striking aspect of commodity price weaknesses over the previous month or so. The oil index was down 9% on the month and 41% on the year. The sharp falls were associated with Opec's conference, during which members failed to agree on price raising measures.

Turning to the domestic economy, Mr Vickers noted that GDP growth in the third quarter was revised down, there was a sharp bounce-back in investment but household expenditure growth was a little weaker than expected. However further revisions were likely of the GDP figures. Turning to the fourth quarter indicators, Mr Vickers noted that the news from the high-street was quite weak, the November CBI distributive trade survey was gloomy and the Bank's Agents reported weak turnover in all regions apart from parts of the South East. Turning to industrial production in October, manufacturing output showed the third consecutive monthly fall and industrial production was flat. Some of the forward looking indicators implied continuing further reductions in manufacturing outputs. There had been some recent strength in construction orders but across the economy as a whole surveys of activity had continued to indicate deterioration. All three CIPs surveys were now below fifty on their index numbers and while consumer confidence had recovered a little in November it remained low. The CBI industrial trends survey showed no further deterioration but a continuing low level of confidence which was consistent with stock level data.

Mr Vickers also noted the output price figures which showed the largest annual fall since the series started. Retail prices were broadly in line with expectations. The labour market was at or close to a turning point. Mr Vickers noted that there was an increase, due to back revisions, of more than 400,000 in work-force jobs since September 1995, but this was not news and it affected the level not the profile of productivity. Mr Vickers asked Members of Court for their

comments, in particular, on sectoral trends and on what was happening to consumer expenditure, which remained a puzzle.

Turning to the markets, Mr Plenderleith said that the main factors were a focus on the slower growth prospects of the major industrial economies and continued hesitation and fragility in emerging market economies, with trading continuing to show a strong aversion to risk. He drew attention to the fact that liquidity was tending to dry up ahead of the end of the year and, particularly this year, ahead of the euro conversion weekend. He also noted that emerging market spreads had widened a little during the course of the month, reflecting the fact that there had not yet been full approval of the Brazilian package by the Brazilian congress. In the domestic markets, Mr Plenderleith drew attention to a continuing further fall in bond yields, with ten year German and French bonds below 4% and gilts back below 5% and indeed down to 4.5%, which was the lowest level in modern times. The equities market, after a dip in November, had returned very close to recent highs. This was not consistent with the bond market picture, and was one of the current puzzles. Mr Plenderleith also noted that chart 3 on the convergence of euro-area currencies would disappear and would be re-cast at the next meeting to show the euro area as a whole.

Mr Bailie said that most of the companies to which he talked are predicting a down-turn next year even though it had not happened yet. This was a question of confidence about the future against current reality. The Governor commented that this summed up the situation very well. Sir Chips Keswick commented that the FTSE100 index was becoming a distorted measurement which did not bear any relation to what was happening elsewhere in the market. He noted that the FTSE250 index was showing nothing like as much optimism. Sir David Cooksey noted an unhealthy amount of money going into tracker funds, and said that was what was driving prices in the FTSE100 index.

Mr Buxton commented that prospects were getting worse. One of the problems was the huge difference in performance across different parts of the economy, and his bank was seeing more companies going into business support arrangements and also more receiverships, though from a very low base. The situation was however very different from the beginning of the nineties, because company liquidity was very much better.

The Governor commented that a slowdown had been needed and the question was whether the scale was greater than needed and expected.

Mr Neill noted that the European car industry had defied all the projections made by the industry's leaders, and sales had been good across Europe. The forecast for the UK next year was 2,000,000 sales, down 6.7% on this year. But he noted that after a small fall in October and a flat November the first ten days of December had shown a 3.6% increase, against a first half of December 1997 which had been quite buoyant. He suspected this might not tail-off. He also noted that in the first ten days of December, compared with a year earlier, Rover had halved sales and Peugeot had doubled, while Ford was down. For next year, most manufacturers had cut schedules so the first quarter should see lower production. However, next year would be confusing because of the change in the date for registration numbers, and changes in excise duty.

In reply to a question by Mr Allsopp, Mr Vickers said that survey evidence was pointing to fairly high but not enormous stock levels. The Bank's projection contained a substantial negative contribution from stock building next year. The fact that stocks were fairly high suggested that if consumer demand did rebound there was clearly plenty available to sell. Mr Allsopp commented that the problem was not the level of stocks but the attitude to stocks that people already had. Mr Vickers replied that surveys such as the CBI distributive trades had been giving similar answers on the question of stock for several months. The Governor commented that the amounts were not huge and had been assumed in the forecast.

Sir David Cooksey noted the difficulties of clothing retailers which made substantial mark downs and were preparing for even larger ones after Christmas. This reflected huge over-stocking by Marks and Spencer in particular and was a real sign of depression in that particular sector. Among technology-based companies, delays in orders were being seen across the board. He noted that among pharmaceutical companies, a new wave of advances were coming through, reflecting increased costs and the shorter lives of products. He expected a fall out in that area, with mergers being forced on the industry.

In reply to a question from Sir Alan Budd about the extent to which the clothing industry's problems were due to the replacement of domestic production with imports, Sir David Cooksey said it was necessary to separate Marks and Spencers from the rest. The rest had been buying

overseas for a very long time, reinforcing the tendency by British manufacturers to source more overseas than at home. However, there was a massive shift underway at Marks and Spencers' suppliers. M&S was over-priced compared with the market and was pressing for change, so its major clothing suppliers in the UK were rapidly re-sourcing their products from the UK to the Far East. Mr Bailie noted in this context the movement of textile production away from Northern Ireland, which was very dependent on the industry. Ms McKechnie noted the importance of parallel imports and of legal actions by brand owners. Legal uncertainty had held back the growth of imports.

Sir David Lees commented that with greater openness in discussion of monetary policy there must be greater awareness in the country that it was possible to influence the MPC through the answers given to forward looking surveys. Was the Bank able to carry out or to encourage some form of quality control of surveys? The Governor said there was nothing that the Bank could do directly about quality control. He noted that there were cross checks in the system, including the reports by the Bank's Agents. Professor Buiter noted that the large size of the surveys amounted to a control and it was also possible to check the surveys' predictive quality. He did not believe this issue had made a difference, but it was something to be aware of and to guard against.

Mr Davies noted that the reduction in financial sector income in the third quarter was not repeated in the fourth quarter, but the cost cutting initiatives that began in reaction to poor third quarter trading would probably continue. He noted that in the retail financial services, the number of authorised individuals was ahead of the level expected. Looking forward, however, quite a big shake-up was likely in that sector. The combination of ISAs and stakeholder pensions was going to make some large sales forces unnecessary. That would spur more consolidation in the industry, and cost cutting. The prospects for employment were relatively poor, but there was no sign of a catastrophic fall in financial services activity.

MPC Procedures (Messrs Vickers, Plenderleith and Tucker together with Professor Buiter and Sir Alan Budd in attendance)

With reference to a Minute of 13 October 1998 Mr King noted that Non-Executive Directors were aware of their responsibilities under the Bank of England Act. There had been a preliminary discussion in October and the paper now before Court was one of a series to help

Directors take a view on the procedures of the MPC. He proposed a series of Court discussions, each accompanied by a paper. The one now before Court was about procedures, and explained a month in the life of an MPC member. The next paper would be about the quality and relevance of the work of Bank of England staff, which he noted was now called the Allsopp Review. This would be followed by a paper about the information taken into account by the MPC, covering sectoral and regional information, as mentioned in the Act, and also international information, because Court had expressed a special interest in this. There would then follow a paper on the resources of the MPC. These papers were the first part of the work to be put to Court. The second part came under the heading of peer review. It was felt that it would be helpful to have some feedback on procedures from peers of the Bank of England. This would be done in two forms: letters had been sent to a number of central banks that had attended a pre-MPC meeting, and they would be writing reference reports directly for the use of Non-Executive Directors, probably for the February discussion. Second, the IMF which had examined the Bank of Canada's procedures, was preparing to do a similar exercise for Bank of England procedures. It had been arranged for Michael Deppler, who was leading the UK Article IV Mission, to meet Non-Executive Directors that afternoon to discuss the pre-MPC meeting and the procedures of the MPC as a whole, which he had been studying for the Article IV consultation.

Introducing the background paper before Court, Mr Tucker, commenting on the pre-MPC meeting, said that it was important for Members of Court to be aware that not only did members of the MPC have a day's briefing but in the intervening weeks they received short notes on all the key pieces of data. The meeting was thus less arduous and concentrated than it might first appear. The task of the staff was to synthesise all the information of the previous few months. Any particular meeting had to be structured, but the meetings also needed to evolve month by month, and that had been the case. For example, there was now more international material than a year ago, and during the Autumn turbulence the order of the day had been switched, with financial markets, emerging markets, and particularly the Brazilian situation, coming first.

At the monthly meeting of the MPC itself, the Wednesday afternoon was devoted to discussing issues identified by Committee members, without getting directly into policy choices. On the Thursday morning the Committee went into policy making mode. Mr Tucker said that his perception was that Committee members did not go to that meeting with prepared statements

but adapted what they said and their conclusions to the views of their colleagues, expressed at the meeting.

Turning to the forecasting process, Mr Tucker said that the balance between structure and flexibility needed to be different. But it was both more structured and more flexible than when the process had begun. The forecasting process mixed a bottom-up approach with a top-down one, involving a certain amount of iteration.

Apart from the key forecast meetings and policy meetings, the MPC had two other types of meetings: special topic meetings covered issues such as asset prices, and purely procedural meetings covered issues such as the timetable of the publication of minutes. In this context he noted a new series of meetings on media messages and events.

Sir David Lees asked whether Directors could assume that all members of the MPC were content with the process and whether different members of the MPC used the same model to reflect the data or whether they had different models of the economy into which they plugged the data. He also commented that given the fallibility of the Office for National Statistics on earnings he was surprised that one of the Agents' surveys listed in an Annex to the background paper, was not on earnings. The Governor noted that the Agents had in fact investigated earnings when they carried out a survey of bonuses in July, which at the time had been the main issue concerning earnings. Turning to the procedural questions, the Governor said it was open to members of the Committee to raise points about procedures, and these would be discussed. There had been no outstanding issues on procedures, so he assumed that the Committee was, by and large, content. Turning to the question of models, he said that in broad terms there was a good deal of uniformity in the Committee, and this had been reflected in the exercise by the Treasury Committee which had asked each individual member for their views on a number of questions. Directors might find the MPC submissions interesting to read.

Professor Buiter said that he was broadly happy with the procedures but the pre-MPC meeting needed re-thinking, and the Committee was in the process of doing that. A meeting of that kind was necessary but there were aspects that could be improved to make it less of a data drop and more selective. The Wednesday and Thursday Policy meeting he found satisfactory. Turning to the Inflation Report, he said some aspects of the procedure should be reviewed, particularly in terms of the unbounded growth of the number of meetings involved, and he noted that there

were issues to do with the content of the Inflation Report and the Inflation Forecast. Aspects of both needed continued refinement. Sir Alan Budd noted that he had been marking presenters of the pre-MPC meeting out of 10. One factor he assessed was the percentage of their time that was relevant to the decision to be taken. He would pass his views on to Mr King. Turning to the models, he noted that members did in effect have models in their heads, and did not all completely agree how the economy worked. He believed there were very deep and interesting questions about the forecast.

Ms McKechnie said that the outside world particularly wanted answers to what went wrong with the earnings data from the Office of National Statistics. Her instinct was for NedCo to say that Court had been alerted. But it would need to see the report on the ONS. Mr King said it had been hoped to complete the report before the New Year, but that was no longer going to be the case. There would be a new method for calculating the earnings data, but it was unclear whether publication could resume in mid-January. He certainly hoped that the ONS would be in a position to resume in February. The report would be available before NedCo's MPC procedures review. The Governor noted that it was important to note the NedCo review was of the MPC not of ONS procedures.

Mr Allsopp said that a big issue would be the June interest rate rise. But Directors had to be very clear that Court's role was not a review of the decision but whether the procedures were followed. He commented that the procedures followed after the discovery of the difficulty with the earnings data were impeccable. Ms McKechnie said that Court was responsible for making sure the MPC had the resources it needed to conduct its business properly, and if it did not have the information it needed to make the best decisions, that must be a Court responsibility. Dame Sheila Masters noted that at every point the Bank had been alerted about the earnings issue, had considered what its response should be and each time it had been overtaken by an external decision.

In reply to a question from Mr Allsopp about the publication of the Bank's forecasting models, the Governor said the Bank had hoped to publish by the end of the year. Now it was more likely to be the Spring.

Dame Sheila Masters said that the procedures paper was very useful. She noted that the

Non-Executive Directors had themselves asked for a separate paper on the procedures they used in reviewing MPC procedures, and she hoped to have that before Court in January.

FINANCIAL STABILITY ISSUES

Developments in International Markets (Messrs Clark, Vickers and Plenderleith in attendance)

Mr Clark said that his perception was that the IMF programme was possibly a little more fragile than a month ago. Though the roll over of lending by banks to Brazil was going reasonably smoothly, interest rates were higher than assumed in the IMF programme, which had an impact on the fiscal position. In real terms, rates were still between 20% and 25%, which was not sustainable. The other question was capital outflows, which had been a few hundred million dollars a day at one stage but had reached broad balance at the time of the launch of the IMF programme. Outflows were now showing signs of rising again, and at times had risen back to a few hundred million dollars a day. This made it hard to decrease interest rates, because they were at their present level to hold the Real in its band. It was not at all clear that Brazil was out of the woods.

Mr Plenderleith noted that the Bank was involved in the support operation for Brazil. The financial package was more that $40bn, and close to half of that was from the IMF. A further proportion was from major international development institutions and about one third from some twenty leading central banks. Brazil had already drawn on the IMF facilities and was planning a first drawing on the central bank facility during this week. The Bank of England was one of the participants, with a contribution of $1.25bn. This was not directly a Bank of England risk. The Bank for International Settlements would be putting up the funds to Brazil under a guarantee from the participating central banks. The Treasury would indemnify the Bank, since it was part of an inter-governmental arrangement. The Bank would keep a small part of the margin paid by Brazil to cover its costs in setting up the arrangement, and the operational risk of handling it. The risk was substantially covered by the Treasury indemnity. In response to a question from Mr Buxton, the Governor noted that Brazil paid a substantial margin to the BIS, which Mr Plenderleith noted was over 400 basis points, most of which went to central banks and most of that the Bank of England passed on to the Treasury.

Mr Plenderleith noted that if the loan were fully drawn down the Bank of England would receive about $1mn to cover its costs and risks.

Turning to Japan, Mr Clark said Nippon Credit had been nationalised after a review of its balance sheet had shown negative net assets. The machinery for temporary nationalisation had been used and the bank was under public control and its obligations were explicitly publicly guaranteed. It was a step forward, but there was still a long way to go. Mr Davies said that Nippon Credit had been a lame duck and their UK end had been closed 18 months ago. He commented that the new head of Japan's regulatory authority came to see him recently, and he seemed a determined fellow and would make waves, and this was evidence of it. He noted that the Bank of Japan had invested in Nippon Credit at Yen320 a share and the shares had been bought for Yen1 by the Government.

Sir Chips Keswick commented that he saw a potentially explosive cocktail of risk comprising the Japanese and Brazilian situations, the banking year end and the introduction of the Euro. He asked whether the Financial Services Authority was comfortable with taking all these risks at the same time. Mr Davies said that the character of these issues differed. On conversion to the Euro, the Bank, led by Mr Townend, was at the leading edge in Europe. Japan was a significant macro-economic issue since it was an anchor on world growth but he did not see it as a crisis. Brazil was of a different order: it was a confidence issue and it was difficult to say in advance that market conditions could cope with a major crisis of confidence in Brazil. The package had been intended to prepare the underpinnings of confidence in Brazil, and he hoped it would do that. In response to a question from Mr Allsopp about whether there was a contingency plan if Brazil failed, Mr Clark said Brazil was a very large domino, and there would be a knock-on effect in Latin America and more widely. A failure would be a serious blow to the credibility of the IMF. As with Russia, it would have put a programme in place and found it in serious difficulty within a short space of time. He said he expected that the IMF would try to patch up the Brazilian situation.

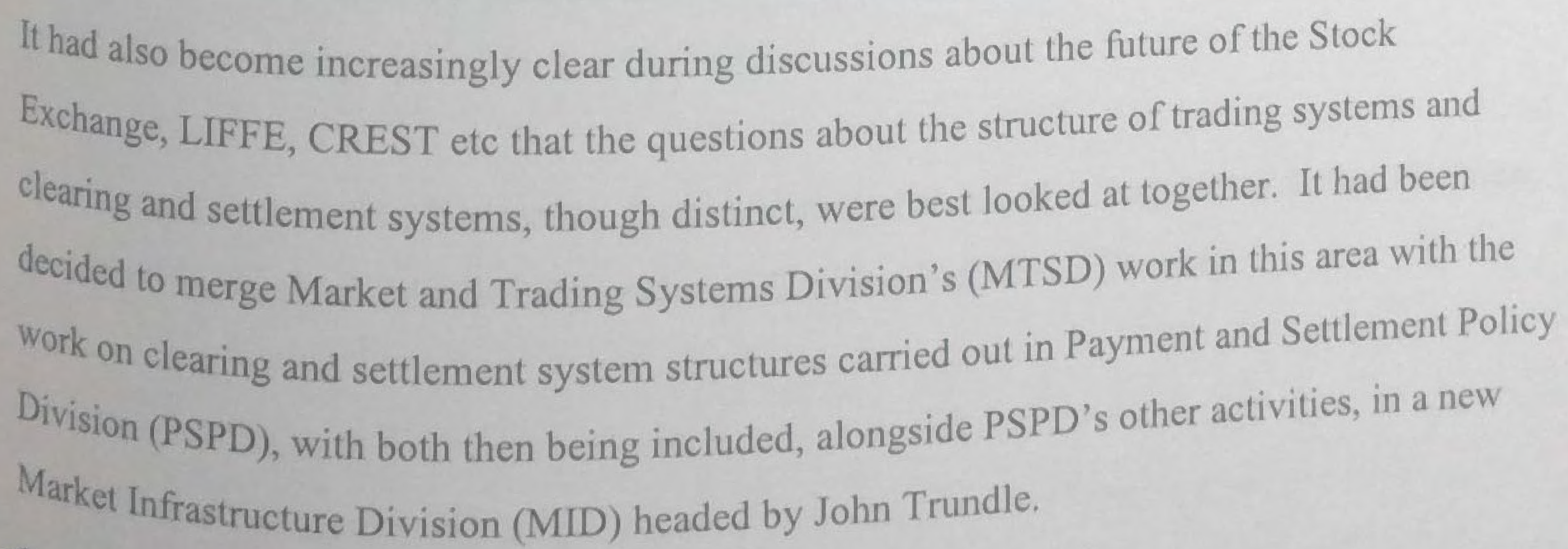
Sir Colin Southgate said that a Brazilian crisis would have a huge effect in the US. His company's Brazilian results last month had been better than expected, and there was a feeling that consumers were more confident. Mr Buxton expressed concerns about contagion if Brazil failed and he also said he was worried that Japanese banks were not prepared for the Year 2000.

They were so concerned about their credit positions that they did not have time to worry about anything else. The Bank of England and the FSA should be taking an interest in this.

Mr Clark said the US had the largest single exposure to Brazil but one or two European countries had significant exposures to Latin America and to Brazil.

On the Year 2000, he said there were signs that lenders were looking a year forward and considering their exposures, which was evident in the yield curves. If credit were to be withdrawn differentially from Japanese banks, that would be quite difficult. In the rest of Asia, apart from Malaysia, spreads were back to pre-Russian levels and there had been significant rises in the stock markets of Indonesia and a number of other countries. There were still issues about how long structural problems would take to tackle. Indonesia was still in great difficulties but Korea was tackling matters energetically. The Governor commented that it would be an interesting new year.

Turning to a restructuring on the Financial Stability side of the Bank, Mr Clark said that the intention was to reorganise the involvement in international financial stability issues, and to recognise in discussions such as those with LIFFE and the Stock Exchange the need to look at trading and settlements together. Commenting on the organisational structure of the Financial Stability area, Mr Clark said FS was established in its present form a year ago. The International Finance Unit, which was newly created at the beginning of this year, had grown to 13 people. A further modest increase in numbers was planned in 1999. Given the importance of its work and the resources now devoted to it, IFU would become a full Division (the International Finance Division), with Andy Haldane as head.



It had also become increasingly clear during discussions about the future of the Stock Exchange, LIFFE, CREST etc that the questions about the structure of trading systems and clearing and settlement systems, though distinct, were best looked at together. It had been decided to merge Market and Trading Systems Division's (MTSD) work in this area with the work on clearing and settlement system structures carried out in Payment and Settlement Policy Division (PSPD), with both then being included, alongside PSPD's other activities, in a new Market Infrastructure Division (MID) headed by John Trundle.

MID would also incorporate the work of City Group, which had until now operated as a freestanding unit reporting direct to John Footman. A core role in the period ahead would be to provide regular assessments of how European developments in general, and EMU in particular, were affecting the competitive position of the UK financial services industry. This would involve drawing on raw material from other parts of the Bank, and close co-operation with John Townend's European team. The City Group would be renamed Competitiveness Group.

FS also needed to reinforce its capacity to analyse market developments bearing on financial stability, extending the surveillance functions on intermediaries and financial flows already undertaken in Financial Intermediaries Division. A new Markets Group would be established in FID to undertake this work, in close collaboration - as now - with Financial Market Operations (FMO).

These changes meant that the continuing elements of MTSD's present brief would move to other parts of the FS Area and MTSD itself would cease to exist.

The existing structure made no provision for analysis of personal sector developments relevant to financial stability. To remedy this, the role of Business Finance Division's (BFD) Corporate Finance Group would be expanded to include responsibility for monitoring such issues, and BFD would be renamed Domestic Finance Division.

Finally, FS was keen to develop the Financial Stability Committee as a major focus for the Area's output, and was reviewing what this should mean for the format of FSC meetings and for the way material was presented to the Committee. Paul Tucker would take on responsibility for co-ordination of the FSC process and Alex Bowen, as editor, would work with him on the monthly assessment prepared for the Committee.

There would then be five Divisions – those mentioned above plus Regulatory Policy Division, whose remit remained substantially unchanged, with effect from 1 January.

Financial Market Operations Issues

Euro Payments in Target

Commenting on the proposals for euro payments in Target outlined in the paper before Court, Mr Plenderleith said that the arrangements would probably need to be phased in progressively over the next month or so and it might not be possible to obtain all the securities wanted before TARGET started operating on 4 January. In that case, the euro the Bank borrowed would partly be in the form of foreign exchange swaps. This might lead the Bank temporarily to exceed the £3bn limit agreed for such swaps and he asked Court to agree to the ceiling being raised temporarily to £4bn for this purpose. Court was content. In reply to a question from Mr Davies about whether the Swedes and the Danes had similar arrangements, Mr Plenderleith said that this was the case. In reply to a question from Sir Chips Keswick, Mr Plenderleith said that he believed the Bank could live well within the €3bn intra-day liquidity agreed with the European Central Bank.

In the absence of Mr Townend, who had been called to a meeting outside the Bank, Mr Clementi described preparations for the euro weekend. The Bank had been working hard towards the conversion weekend. The preparations within the Bank comprised 4 elements: Mr Plenderleith was in charge of the Bank's own systems, and the Audit Committee had looked earlier at this work and believed it was well under control; Mr Townend was in contact with all of the top forty firms in London, representing the bulk of the professional market, and had also produced the December issue of the Practical Issues Quarterly, which was the definitive publication for the whole of the professional markets in Europe; for the weekend itself the Bank was establishing a general enquiries team; finally there was a press team for the weekend, because a large number of enquiries were expected from the media. The relationship with the FSA and ECB would be through Mr Townend's team. Individual firms with company specific problems would be the responsibility of the FSA.

The Bank was ready and so was the majority of British, German, French and other firms in the UK. The Governor commented that the Bank's preparations had been extremely well handled by Mr Plenderleith, and the conversion weekend arrangements more generally were reflected in the PIQ, which was a considerable achievement. This had become a standard work globally for

those preparing for the weekend, which said a great deal both for the Bank and for Mr Townend.

MANAGEMENT OF THE BANK

The Bank's Capital (Messrs Clark, Vickers, Plenderleith and Midgley in attendance)

Mr Midgley said the origin of the paper he was presenting lay in questions by Dame Sheila and Mr Buxton. But as there were a significant number of new Members of Court he was taking the opportunity to provide a wider brief.

The paper was in four parts.

First, some factual points: capital and reserves were £1,260 m of which £200 m were fixed assets (premises and equipment) used by the Bank in providing its main functions. The remainder was invested mainly in financial assets, and provided the Bank with a financial base.

There was no dedicated portfolio of assets matching the financial reserves: investment decisions were taken in relation to reserves plus cash ratio deposits, a wider pool of assets. He drew attention to the composition on page 2 of his paper, and returns earned at end-day on page 3. Two thirds were in assets where the Bank had locked into longer term returns, offering protection against falls in markets rates, and one third was exposed to changes in short-term interest rates. After the reduction in CRDs from £2,560 m to £1,140 m the Bank hung onto existing gilts, and took all the reduction in short-term assets.

Second, the Bank's need for capital and reserves: the risk in any one area of the Bank's banking and market operations was relatively low. The Bank could choose counterparties carefully, and much of what was done was secured, with good collateral. But it was also the case that the changes that had been taking place, and might continue - as listed in paragraph 11 of the paper - were producing some increase in concentration of risk.

If all the Bank's own business needs were included together, then at most they might validate about half of the current level of capacity and reserves. How much more than this the Bank

maintained was really a judgement about the capacity the Bank should have to meet its systemic responsibilities.

Third, the Bank's role in support operations: the Bank, where possible, provided only liquidity, but there was a wide range of potential situations. For example, in relation to value and risk, at one extreme the Bank would lend against good assets and might be prepared to commit a significant part of its capital and reserves. At the other extreme, where the lending was against doubtful value assets – of a failing bank, for example – the bank would put in less.

Fourth, Court's role, in particular in relation to support operations: paragraph 23 of the paper outlined the judgements that Court might be involved in. The first one – the level of capital and reserves – was really there for completeness, in that the CRD discussions with the Government – which Court approved earlier this year - settled the level.

The other key points were that the Executive was committed to informing Court of a potential support situation, just as it informed the Chancellor; and by its nature, use of the Bank's balance sheet in support operations involved judgements about risk. Given the speed at which events unfolded, this required some delegated authority from Court to the Executive.

In response to a question from Mr Buxton about the Bank's investment properties, Mr Midgley said that the £160 m in the paper referred to New Change. The Bank had reduced its use but had a residual occupation at New Change and the rest was let to tenants. Therefore in the accounts it was shown as an investment property. The future of this would depend on decisions made in the Bank's review of its properties. Mr Buxton said that as a general principle he did not believe the Bank should hold investment property unless it had operational reasons. The Governor noted that the Bank had a rather favourable arrangement with the City Corporation so the property was worth more to the Bank than to some others.

In reply to another question from Mr Buxton, Mr Midgley said that the Bank had thought of trying to negotiate itself out of provisions on future health insurance. However, it was very difficult to do that. BUPA had been removed for new entrants but it was thought that the Bank could not change it for existing pensioners. Mr Buxton said that his bank did have ideas of how to get out of such commitments. Mr Buxton also commented that he did not think it was possible to answer the question of whether Bank of England capital was adequate, because it

had the state behind it. Mr Midgley agreed. He said that when the Bank had previously examined this, it had been discussed with Government, and the conclusion was that the Bank would keep its real capital in tact. In response to a question from Sir David Lees about how quickly the portion of the gilts portfolio still yielding 10% was run-off with successive redemptions, Mr Midgley said the half-life of the portfolio was now about six years and the Bank had a cushion for the five years of the CRD agreement. Provided short rates did not drop a lot further, the cushion would last beyond the end of the period. In response to a question from Dame Sheila about when the balance of insured and uninsured risk was last discussed at Court, Mr Midgley said this was three years ago, and Court was due for another discussion. He also agreed that Court had a role in relation to the investment strategy. Both these questions would be brought to Court. Mr Davies noted that in relation to paragraph 22 the responsibility for exploring every option for a commercial solution would normally be for the Financial Services Authority. In reply to a question from Ms McKechnie, the Governor said that since the Treasury owned the Bank, that put the Bank in the situation where it was obliged to negotiate with the Treasury. The protection the Bank had was that Court had to agree the dividend with the Treasury and the reality was that it had to have periodic negotiations. The arrangements currently in place had been intended by the parties to last for five years.

The Bank's Strategy Paper Revisited (Messrs Clark, Vickers, Plenderleith, Footman, Midgley and Berkowitz in attendance)

With reference to a Minute of 18 November the Governor thanked Members who had submitted comments following the strategy discussion held the previous month.

In introducing his paper, Mr Clementi said that the ten Bank Objectives would be important to accountability and would also be useful internally for members of the Bank staff by expanding their understanding of what the central bank was trying to achieve. A number of Directors, in their letters, had expressed concern about whether the ten were sufficiently measurable. Mr Clementi said that Local Business Aims have been geared to map into these ten Bank Objectives and each area had been asked to set out the process by which it would be judged. Court would see that in February, and the Budget would help tie it all together.

He noted Members' comments on Objective 9, the financial objective. This would become a good deal clearer in February, and to an extent discussion should be held back until that month. A policy decision had to be taken on the gilt portfolio and this would be brought to Court at

that time. The Budget would be presented to Court and the Bank would propose what it thought were its key internal financial objectives. It was possible that the wording of Objective 9 would be changed when the Budget was presented.

Turning to CRDs, Mr Clementi noted the lengthy discussion last Autumn and Spring, and said there was a presumption that the agreement would be in place for 5 years. But the arrangements required the Bank to write annually to the Treasury setting out its medium term position, so in February a draft of the letter intended to be sent to the Treasury would also be brought to Court.

Mr Clementi stated that he would like to deal with this matter on the basis set out on page 3 of his paper dealing in order with –

1. confirmation of John Footman's route map;
2. adoption of the nomenclature in paragraph 2 of his note, formally noting that, taken together, the three Core Purposes and 10 Bank objectives constituted the Bank's strategy and objectives for the purposes of the 1998 Act;
3. consideration before doing so of any further points on the list of Bank Objectives; and
4. noting that it would be necessary to return to the issue in February when looking at the Budget. That would set out the Local Area Aims to support the Bank Objectives;

He asked whether Court was happy to re-confirm Mr Footman's route map. Mr Bailie asked whether the Bank was acting in the opposite way to a commercial company, which would normally set out its strategy, and then tell operating units to reflect that. Mr Clementi said the Bank was not a commercial company, but was seeking to carry out efficiently its duties as a central bank. It had a duty to control expenditure, and it did have reserves to invest. The discussion in February would throw more light on the return from investments. The process reflected the fact that the Bank was not in business to maximise returns. Its business was to carry out the central bank's functions it had been given. The Governor noted that the easiest way for the Bank to maximise its returns as a monopoly supplier of liquidity was to raise interest rates but it could not be in that business, therefore control had to be over expenditure.

Dame Sheila noted that the Act required financial management objectives to be set and that was what the Bank should try to respond to. Sir Chips noted that the Bank may not be a

commercial organisation, but he wished it to be made clear that it did run commercial risks. Mr Neill said he entirely accepted Mr Clementi's point about the Bank not being a commercial organisation but, in relation to Objective 9, it was important for senior management to set challenging goals at the start of the budgeting process, otherwise it would be ten times more difficult to get them to think creatively. The Governor agreed, and said the Bank would come back to Court with that in February. He asked whether there were any other comments apart from Objective 9, which would be discussed in February.

Sir David Lees suggested that in point 10 the wording should be changed to read "to keep under review" the management of the Bank's balance sheet. He also noted that there was no reference to health, safety and the environment, and a short reference to those would make the objectives more complete. Sir Colin Southgate did not like the words "to improve" the range and quality of information. It implied it was not good enough at the moment. Mr Neill suggested the words should be changed to "to continuously improve". The Governor said that would be looked at.

The Governor then asked whether Court was content to proceed, subject to incorporation of the comments on the Bank Objectives, on the basis outlined. This involved adopting the process reflected in the route map, and agreeing the Bank's Core Purposes and Bank Objectives taken together, constituted the Bank's strategy and objectives for the purposes of the 1998 Act. Court indicated it was content. The Governor noted that Court would return to the issue in February, when it looked at the Budget, at which time the Local Area Aims that would support the Bank Objectives, measurable where possible, would be set out for Court.

Dame Sheila Masters noted that the discussion referred to the strategy and objectives for 1999/2000 and Court would come back separately in January to the question of 1998/1999.

BCCI – update (Mr Berkowitz in attendance)

Mr Berkowitz noted that he had circulated a paper before the meeting on the judgement, which from the Bank's point of view was very good, because the action remained struck out. Since then, the Court of Appeal had decided to grant general leave to both sides to go to the House of Lords on the judgement, and the Bank was awarded all the costs. The leave to appeal on the main legal issues was not unexpected. There were two smaller points where the Bank failed on

appeal but had been given leave. It had hoped that it would be possible to avoid the need to go through all the factual material but the Appeal Court decided separating the matter was too complex and that it would have to push all the issues upstairs to the Lords. He also noted that of the 320 pages of the judgement, 160 was the majority judges' view and the dissenting judge also gave a 160 page judgement. He found against the Bank on every point. In the High Court and at appeal the Bank led 3-1 on aggregate, but that did not really count because the argument would start again in the House of Lords. The timing of the Lords hearing was possibly June, but more likely to be in the second half of the year. There was at least a possibility that the matter would go to the European Court of Justice.

Mr Davies noted that if the appeal to the Lords was upheld, there would be dramatic consequences for banking supervision, going forward. It would remove the supervisors' discretion. If they came across a bank that was not meeting every Schedule 3 criterion, they would have to shut it. He said it might be necessary to consider whether there should be Financial Services Authority input to the House of Lords on the implications. The case was not just about BCCI. Mr Berkowitz said that he was in close touch with the FSA lawyers and the Bank had kept the Treasury solicitor informed at every step.

In reply to a question from Mr Buxton, the Governor said that the Bank was not indemnified in this matter by the Treasury. He noted that the action was originally $9 bn but was now down to $0.5 bn. Mr Berkowitz noted that the claims of the 6,000 depositors had a face value of £600 m. They had had 45% back from the liquidators. Interest would have to be added to the face value. There was also a complex issue of who could make a claim and in respect of what amounts. The face value was not necessarily the damages recoverable. In reply to a question from the Governor about whether, if claims were upheld, it gave grounds for others to claim, Mr Berkowitz said that he was reasonably confident that that was not the case. Time limits might also apply. He was hopeful that it would not happen as the law stands. The Governor agreed with Mr Buxton that if any claim had to be met it was likely that it would have to be from the Bank's capital. Mr Berkowitz noted that the outcome would be referred to in the Bank's Annual Report and Accounts, but there was currently no provision because there was no claim.

Appointments as Head of Division

In accordance with 'Matters Reserved to Court', Mr Clementi drew Court's attention to two changes at Head of Division level. Mike Phillips had decided to retire, and on 18 April 1999 he would be succeeded as Head of Market Services Division by Chris Mann. Secondly, and with effect from 1 January, Andy Haldane would become the Head of the International Finance Division; this followed the redesignation of the International Finance Unit.

Directorships of Bank Subsidiaries

The Governor reminded Court that Graham Kentfield would be retiring at the end of this month and Merlyn Lowther would take his place as Deputy Director, Banking and Market Services and Chief Cashier. He pointed out that this would give rise to a number of changes to the boards of certain Bank subsidiaries and shareholdings and he drew attention to a Recommendation in Members' folders which read as follows:-

'that consequent upon the retirement of Mr G E A Kentfield at the end of December 1998 and the appointment of Ms M V Lowther in his place and pursuant to Section 375 of the Companies Act 1985, as appropriate, and until otherwise resolved by the Court of Directors:-

1(a) Ms Lowther and Mr Midgley shall become Directors of **Minories Finance Limited** in place of Mr Kentfield. The Board will then consist of Mr M J Harper, Chairman, Mr P Brenan, Ms M V Lowther and Mr G Midgley;

1(b) Ms Lowther, or failing her, Mr Midgley, or failing him, Mr Harper, or failing him, Mr Brenan be authorised to act as the representative of the Governor and Company of the Bank of England at any meeting of **Minories Finance Limited**;

2(a) Ms Lowther shall become a Director of **National Mortgage Bank plc** in place of Mr Kentfield. The Board will then consist of Mr I H Davison, Chairman, Mr Noel Manns, Mr M Andrews, Mr K Allen and Ms M V Lowther;

2(b) Ms Lowther, or failing her, Mr Davison, or failing him, Mr Manns, or failing him, Mr Andrews, or failing him, Mr Allen be authorised to act as the representative of the Governor and Company of the Bank of England at any meeting of **National Mortgage Bank plc**;

3(a) Ms Lowther shall become a Director of **The Securities Management Trust Limited** in place of Mr Kentfield. The Board will then consist of Mr T A Clark, Chairman, Mr Gordon Midgley, Mr G P Sparkes and Ms M V Lowther;

3(b) Mr Clark, or failing him, Mr Midgley, or failing him, Mr Sparkes, or failing him, Ms Lowther be authorised to act as the representative of the Governor and Company of the Bank of England at any meeting of **The Securities Management Trust Limited**.

It was also recommended that:-

(A) Mr Tucker shall become a Director of **Financial Law Panel Limited** in place of Mr Kentfield. The Board will then consist of Lord Donaldson, Chairman, Mr C Bamford and Mr P M W Tucker;

and that:-

(B) the 925 shares – representing 92.5% of the equity – in **The Securities Management Trust Limited** held jointly by Messrs Midgley and Kentfield in a nominee capacity for the Governor and Company of the Bank of England be transferred to Mr Midgley and Ms Lowther, as a joint holding, in the same nominee capacity; and

(C) the one share – representing 50% of the equity – in **Houblon Nominees** held by Mr Kentfield be transferred to Ms Lowther.'

Court APPROVED the recommendation.

Recommendations from the Chairman of the Remuneration Committee

In accordance with Schedule 1, Paragraph 13(5) of the Bank of England Act 1998, the Governor and the two Deputy Governors absented themselves and in accordance with Paragraph 13(3) of the above Schedule, Dame Sheila Masters took the Chair.

Dame Sheila invited Sir Colin Southgate in his capacity as Chairman of the Remuneration Committee to present the Committee's recommendations to Court. They read as follows:-

'To recommend a 2.5% salary increase for the two Deputy Governors, three Executive Directors, four external MPC members but not Mr Berkowitz or Mr Brealey.

For Sir Peter Petrie, it was agreed that he should have a salary supplement of 5% in addition to the 2.5% salary increase, and that he should be offered a fixed term one year renewable contract.

The Committee also agreed that future appointments to the Monetary Policy Committee and as Advisers to the Governors should be made on standard contractual terms and that these should include a 15% salary supplement in lieu of membership of the Pension Fund. The cap would not be applied to this salary supplement. It was agreed that it was desirable to look into how these salary supplements could be made tax efficient if the money went into a personal pension scheme. If this was done, it was necessary to know whether the recipient scheme could accept the contribution. Some worries were expressed about the implications for life cover but it was noted that the Bank would not have to pay National Insurance.

The Committee agreed that while the contracts just negotiated with individual MPC members should be honoured in their present form, on reappointment they would go on to the standard contract.

The Committee decided that it would recommend against formal disclosure of the remuneration of members of the Monetary Policy Committee. The Bank would continue to disclose the full-time rate and would tell enquirers that the amount was pro-rated for those who worked shorter hours.'

Sir Colin said that in the case of Sir Peter Petrie, a 5% salary supplement was being recommended, because his pension had ceased. The Committee had debated with the Governor, who had hoped to extend Sir Peter's contract for 5 years, and agreed that it would be renewed on a yearly basis. He noted the recommendation that an Executive Director's base salary from 1 January. would be applied at that date and he would move into the Court Pension Scheme. He also noted that got very little out of that transfer because he had been with the Bank a long time.

The key point of the Remuneration Committee meeting was its discussion about MPC Members and Advisors to the Governors. Contracts with different Members of the MPC were in rather a muddle. As from re-appointment, all would go onto similar contracts. That implied that if current Members were re-appointed their contractual terms would be changed. Putting them into the pension scheme was costly to the Bank and inefficient in many ways. They would instead receive a fixed contract with a 15% salary supplement and for each Member the Bank would look at the most tax efficient way of paying it. He noted that Remco would like to see the same rules applied to any other form of outside consultant brought into the Bank on a fixed term basis.

He also noted that the Remuneration Committee had dealt with one of the MPC members who had requested all the benefits of employees, for example mortgages. Sir Colin noted that he had written a letter of refusal to the member who had since responded happily; and Sir Colin hoped peace would reign until the end of the member's term.

Turning to disclosure, Sir Colin said the Committee had discussed the issue and did not think it necessary to disclose the remuneration of MPC members. They were not covered by Cadbury or Greenbury rules. Obviously the Bank could respond to a request by outsiders for information about their remuneration. It was not however appropriate to disclose it in the accounts. The Bank would say that for part-timers their remuneration was pro-rated. In response to a suggestion from Ms McKechnie that the Bank would receive a lot of criticism by not making that public, Sir Colin said that the MPC members were not Directors. Dame Sheila said that a straight question about their remuneration should be given a straight answer but the Committee did not feel it necessary to put it in the Annual Report.

Mr Neill said he was happy to support the recommendations but he saw one issue. 2.5% was in line with inflation, but the reality was that the Bank wanted the best people in the years ahead and would have to recognise what was happening in the markets. He asked to what extent Remco had looked at comparable jobs. Sir Colin said that the Committee had been through this debate with the Governor's pay and he himself had spent a period in the Treasury debating the issue. It was felt by the Treasury and by the Governor that if there was a 2.5% target it was appropriate to stick to that level for salary increases. Sir Colin said that although he took Mr Neill's point, the Remuneration Committee at the time of discussion over the Governor's pay looked at the pay of other central bank Governors around the world. He was not out of step

with his peers. He was of course out of step with the private sector but he was not in the private sector and had chosen not to be. Dame Sheila noted that Mr King had received a significant increase with his new job and that Mr Clementi had come with his eyes open from the private sector.

Mr Buxton noted that there was a much bigger issue on pay at lower grades than at the top of the Bank. The Bank was in direct competition with the private sector and was probably not paying enough in some parts. Dame Sheila said she agreed, and a number of exercises were under way, particularly looking at benefits, where the package in the Bank was not easily valued by staff.

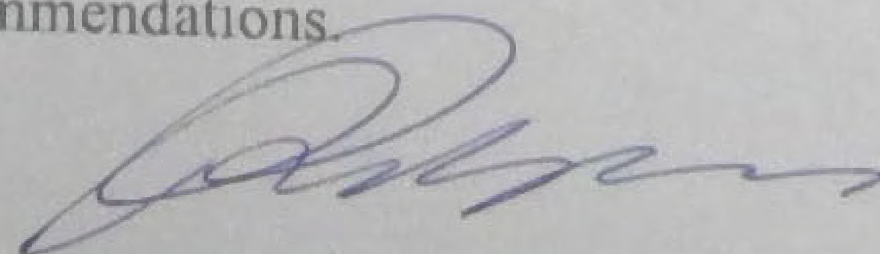
In response to a question from Mr Allsopp about whether MPC members were happy with the proposal for a standard contract, Sir Colin said that he had received only one letter and had had no word that anybody else was unhappy. The easiest solution would be just to hand members a contract on re-appointment. The proposed contracts were a blend of the existing arrangements. In response to a question from Sir Neville Simms about what would happen if a recruit to the MPC did not wish to accept the salary and the standard contract, Sir Colin said that if that happened it would have to be reviewed.

Sir David Lees noted two by-products of the discussion. First, the Audit Committee had met shortly before, and with Mr Clementi's approval concluded that the report on remuneration in the accounts was so large in relation to the whole that given the additional responsibilities remuneration ought to be broken out from the accounts and put into a separate report in which the Bank dealt with all these issues. Second, the Audit Committee had asked Mr Clementi to think about whether the title of the Court pension scheme should be reviewed because there were only three eligible Members currently on Court: the Governor and the two Deputy Governors. Sir Colin Southgate said he believed that at some stage the two pension schemes should be merged. Sir David Lees said he agreed, and noted that it would be possible to have differing benefits.

Dame Sheila Masters asked whether Court agreed to the recommendations of the Remuneration Committee.

Court noted and APPROVED the recommendations.

Sheila Masters



20 January 1999