The Bank of England: how the pieces fit together

*The **Governor** of the Bank, Eddie George, discusses*[1] *the Bank's functions as a central bank. Drawing on the Bank's internal 'mission statement', he explains and illustrates the three core purposes: maintaining the integrity and value of the currency; maintaining the stability of the financial system, both domestic and international; and seeking to ensure the effectiveness of the United Kingdom's financial services. He emphasises the relevance of each of the core purposes to the other two and describes how they all fit together to make a coherent whole.*

This is the fourth and last in the series of LSE Bank of England lectures. My predecessor as Governor, Lord Kingsdown, began the series by making the case for price stability as the immediate objective of monetary policy. In my own earlier lecture I spoke about the pursuit of financial stability—describing our oversight of the financial system and our role as lender of last resort to the banking system. And in the third lecture, just over a year ago, the former Deputy Governor, Rupert Pennant-Rea, spoke about the international context within which we endeavour to achieve these fundamental, twin, objectives of monetary and financial stability.

If you had invited any major central bank to deliver these lectures it is quite likely that they would have chosen to speak on these three topics. And, while there would certainly have been important national differences of detail, it is likely, too, that the substance of what they would have said would have been much the same. The pursuit—nationally and internationally—of monetary and financial stability is the essential *raison d'être* of central banks everywhere, and there is nowadays a broad consensus—both across countries and within countries across much of the political spectrum—about what that involves. But once you go beyond that level of generality, each central bank is unique—in terms of its constitutional position, the range of its activities, its size, structure and organisation, and so on.

So in this final lecture I should like to talk quite specifically about the Bank of England, discussing the institution as a whole and how the different pieces fit together.

The Bank's role

The Bank of England Act, which brought the Bank into public ownership in 1946, makes no mention whatsoever of the Bank's role or the purposes for which it exists. The Act explicitly defines the constitutional relationship between the Bank and the government, providing that:

> 'The Treasury may from time to time give such directions to the Bank as, after consultation with the governor of the Bank, they think necessary in the public interest . . . subject to which the affairs of the Bank shall be managed by the Court of Directors . . .'

The Act also empowers:

> 'the Bank, if they think it necessary in the public interest, to request information from and make recommendations to bankers, and may, if so authorised by the Treasury, issue directions to any banker . . .'

The Bank's 1946 Charter goes into considerable detail on the conduct of Court—even fixing the remuneration of Directors in respect of their services on the Court at £500 a year. And it describes circumstances in which a Governor, Deputy Governor or Director shall vacate his office, including, *inter alia*,

> '. . . if he be found lunatic or become of unsound mind'.

But, for reasons that are explained in John Fforde's admirable history, *The Bank of England and Public Policy 1941 to 1958*, and in contrast to other cases where central banks were set up *ab initio*, it was not felt necessary in this country either to define in statute the central bank's duties and responsibilities or to specify the purposes for which its powers were to be used, because, in John Fforde's phrase, 'the central bank was there already, the evolutionary product of growth over time'.

The Bank's role has continued to evolve over the past 50 years within the flexible framework of the 1946 Act. It has, of course, adapted to changes in government policy, including in particular the progressive movement away from intervention and direct forms of control in many areas of the Bank's activity; and it has had to respond to external changes in the economic and financial environment. But the essential substance of its role has not greatly altered.

Some five years ago we decided with our Court of Directors, as the basis for our internal management framework, to define our 'core purposes' in what is in effect a 'mission statement'. It begins with the general statement:

(1) In a lecture at the London School of Economics delivered on Thursday, 25 January 1996.

> 'As the central bank of the United Kingdom, we are committed to promoting the public good by maintaining a stable and efficient monetary framework as our contribution to a healthy economy'.

In pursuing that goal we identify three core purposes:

- Maintaining the integrity and value of the currency.
- Maintaining the stability of the financial system, both domestic and international.
- Seeking to ensure the effectiveness of the United Kingdom's financial services.

The first two of these purposes you will recognise, at this level of generality, as the essential purposes of all central banks. The third—concerning the effectiveness of the United Kingdom' financial services—is more unusual, and perhaps peculiar to the Bank of England which has a long-established tradition of encouraging the financial services industry in this country to meet the needs of the wider economy both domestically and as the world's major international financial centre.

Maintaining the integrity and value of the currency

In elaborating our monetary stability purpose, our statement goes on:

> 'Above all, this involves securing price stability as a precondition for achieving the wider economic goals of sustainable growth and employment. We pursue this core purpose by influencing decisions on interest rates, on the basis of economic and financial analysis of developments both at home and abroad; by participating in international discussions to promote the health of the world economy; by implementing agreed policy through our market operations and our dealings with the financial system; and by maintaining confidence in the note issue'.

I want to make two comments arising out of that—about why we place so much emphasis on monetary stability and about the activities we undertake in pursuing it.

I am well aware that some people still think that the Bank sees price stability as an end in itself—to be pursued without regard to the implications for the truly good things in economic life like the growth of activity and employment and increasing welfare.

Now there is a sense in which we do see price stability as an end in itself—as I hope you all would if you were responsible for issuing some £20 billion worth of promises to pay in the form of banknotes for fixed nominal amounts which may be worth very much less in real terms by the time they are presented. 'Honest' money is desirable in its own right, and helps to ensure transparency in relationships between borrowers and lenders.

But more fundamentally the reason we are committed to price stability is not as an end in itself but because we see it as a means to the end of precisely those good things in life which our critics assume we disregard. Implicit in their criticism is the notion that the aims of price stability and economic growth are necessarily in conflict with each other. Our conviction—based on the repeated experience of the past 50 years—is that such conflict is illusory in anything other than the short term. Time and again we have seen attempts to stimulate the economy directly result in a relatively short period of faster economic growth, followed by recession brought on by the policy restraint which was eventually unavoidable to bring increasing economic imbalance and accelerating inflation back under control. We therefore see permanent price stability as a necessary condition for achieving steadier, sustainable, growth into the medium and long term. It can also contribute indirectly to increasing the sustainable rate of growth, improving the efficiency of the economy by enabling economic decisions of all kinds to be based on real considerations rather than on speculation on the inflation outcome, and by enabling relative price movements to transmit more meaningful signals about resource allocation which are otherwise masked by erratic changes in the general level of prices.

This is essentially the case for price stability—the case for 'sound' money—developed by Lord Kingsdown in his initial lecture. The point I would emphasise is the relevance of price stability, and related economic stability in a much broader sense, to our other core purposes, financial stability and the effectiveness of our financial services in meeting the needs of the wider economy.

The link from monetary stability to financial stability is very clear and was touched upon in my own earlier lecture. Monetary instability, and the volatility in financial markets which it engenders, are probably the most serious of all the various types of risk that banks and other lenders or investors have to cope with. If you look around the world, almost every case where there has been a serious threat of systemic financial disturbance can be traced back to macroeconomic policy failures of one kind or another. Monetary instability leaves financial institutions generally vulnerable to abrupt changes in the creditworthiness of borrowers or other sudden shifts in asset values that are extraordinarily difficult to predict or to insure against. Monetary stability is therefore fundamentally important to financial stability as well as to the long-run performance of the economy.

But monetary stability contributes, too, to our third core purpose—the effectiveness of the financial system—going beyond the reduction of financial risk.

One of the most frequent criticisms one hears about the financial institutions in this country is that they take an excessively short-term approach to lending and investment. That is sometimes put down to our particular institutional structure. What is clear in that debate, however, is that high and variable inflation and the economic instability that it reflects would tend to engender short-term attitudes regardless of the institutional structure. Longer-term lending would be deterred, for example, by the uncertainty premium that would necessarily be included in long-term interest rates, and long-term rates would also incorporate an element of compensation for the expected erosion of the real value of the loan capital, effectively representing early capital repayment. Given their past experience even nominally short-term lenders will tend where they can to recall their loans at the first sign of downturn while there is value left in the borrowers. And more generally it would be entirely rational in an unstable environment for investors—whether in real or financial assets—to look for a rapid payback rather than to the longer term. I do not claim that instability is necessarily the whole story—there may well be other factors. But our history of monetary instability must be an important influence on the behaviour of our financial institutions, and for that matter of the boards of our industrial and commercial companies, especially their finance directors. To this extent greater monetary stability can deliver, not just a double, but a triple whammy.

The case for permanently low inflation, as a necessary condition for achieving steadier and more sustainable economic growth, has gained increasing acceptance in this country over the past 20-odd years. This is reflected in the political decision by the Government to set an explicit inflation target—of $2^1/_2$% or less for the indefinite future—as the immediate objective of monetary policy. The Labour Party, too, has committed itself to setting a low inflation target if it comes to power.

Given that political decision, the process of monetary policy *formulation* is essentially a technical one. The Bank's role is to provide technical advice on the policy, and in particular on the short-term interest rate, that it considers necessary to achieve the inflation objective. Decisions about monetary policy remain for the Chancellor—consistent with the 1946 Bank of England Act. That process is now uniquely transparent and has given rise to a certain amount of public interest and debate. That is a subject for another occasion. What matters in the end is the results, in terms of our performance—on inflation but also on growth and employment. All I would say is that we have made steady progress in all these respects over the past three years or so, and the prospects remain very encouraging.

The Bank is also responsible for the *implementation* of monetary policy decisions through its operations primarily in the money market, but also, as agent for the Government, in the gilt-edged and foreign exchange markets.

For the most part these activities, and the other banking services which the Bank provides to central government, are uncontroversial through there is, quite rightly, constant pressure to ensure that they are performed efficiently.

Questions are sometimes raised about the Bank's role in managing the government's borrowing, which some people argue is not a necessary central banking function and may somehow conflict with the operation of monetary policy. And it is true that, like a number of our other activities, government debt management could in principle be organised in other ways. But there is no possibility for conflict that I can see in today's context in this country. The Bank undertakes the government funding program as agent for the Government on the basis of a mandate received from the Treasury, and drawn up essentially independently of the monetary policy process but with the explicit objective of avoiding recourse to monetary financing (ie short-term finance from the banking system) year by year. The essential substance of that mandate is regularly published, as is the outcome. And the bulk of the funding is raised through auctions in the bond markets to a timetable and in amounts that are signalled well in advance. As with the process of monetary policy formulation, the whole process of government debt management is nowadays almost wholly transparent.

From the Bank's point of view our day-to-day involvement in all the main financial markets is an invaluable source of information and intelligence—and enables us to develop an expertise—which are invaluable to us in pursuing all three of our core purposes. In the monetary policy context, understanding of market perceptions and market developments is an important complement to our economic analysis in formulating our advice. It is equally important to us in detecting, understanding, and responding to disturbances that may impact on the stability of the financial system. And it enables us to understand at first hand developments that may affect the users of financial markets, helping us to be better attuned to their concerns. In this respect our activities—as well as our purposes—are mutually reinforcing and relevant to the work of the Bank as a whole.

Maintaining the stability of the financial system

Let me move on to our second core purpose, maintaining the stability of the financial system, which, in terms of our 'mission statement'

> 'we seek to achieve through supervising individual institutions and markets; through monitoring the links between financial markets; through analysing the health of the domestic and international economy; through co-operation with other financial supervisors, both nationally and internationally; and through promoting sound and efficient payment and settlement arrangements. In exceptional circumstances, the Bank may also provide or organise last resort financial support where this is needed to avoid systemic damage'.

Our central banking interest in financial stability is clear. If monetary instability is a potent source of disruption of the financial system, then it is equally the case that general instability originating in the financial system can complicate, even disrupt, our pursuit of monetary stability. It is because of this externality—the potential damage to the economy as a whole going beyond the effect on any particular institution—that all central banks would recognise the *twin* objectives of monetary and financial stability—in the sense of the stability of the financial system as a whole: and it is the same externality that justifies the setting of minimum prudential standards, for systemic reasons, as well as our lender-of-last-resort role.

Even this is not uncontroversial. Some argue here too that there is a potential conflict between the pursuit of monetary stability and concern with financial stability such that if these responsibilities are combined in a single institution then monetary policy punches may be pulled at times for fear of the financial instability they might otherwise create. I can certainly envisage circumstances in which financial fragility is a constraint on monetary policy. It was no doubt a factor, though not an overriding factor, in the United States three or four years ago for example, and it is a factor now in Japan. But you cannot avoid the potential tension just by distinguishing institutionally the two responsibilities. Whoever was responsible for monetary policy in a situation of tension would have to take account of the financial fragility, and *vice versa*, regardless of the institutional structure.

More fundamental questions concerning the extent and nature of the central banking responsibility in relation to the financial system arise from the rapid evolution of the global financial market place, on the one hand, and from increasing public policy interest in quite different aspects of the behaviour of financial institutions, on the other.

Historically, central banking grew largely out of concern for the stability of the financial system, and in particular the banking system, because it was there that systemic risks—the risks of contagion—were concentrated. More recently traditional distinctions between different types of financial institution, including banks, have become increasingly blurred, under the impact of competition and of innovation of financial products and techniques, made possible by changes in technology and the move away from direct financial controls. At the same time financial service businesses of all kinds have become increasingly international in their scope, with London the host to financial institutions from all parts of the world and British institutions established in an increasing variety of traditional and emerging overseas financial markets. Together these developments have contributed to the rapid expansion of financial market transactions, through which intermediaries of all kinds assume exposures to each other, increasing the possibility for shocks originating in one part of the global financial market place to be transmitted elsewhere.

Meanwhile, to varying degrees in different countries, the public policy interest in the behaviour of financial institutions has spread well beyond just an interest in the stability of the financial system as a whole. It extends, for example, to an interest in the financial stability of individual institutions for reasons of depositor or investor, or policyholder or pensioner, protection. It extends to many areas of business conduct in order to protect users of financial services, especially less financially-sophisticated retail users, from abuse of various kinds, ranging from outright deception to failure to give ‘best advice’ or ‘best execution’, involving varying degrees of intervention in the relationship between financial institutions and their individual clients. And it extends, too, to the protection of society more broadly against the use of the financial system to launder drug monies or the proceeds of other organised crime.

Taken together, these developments raise a number of extraordinarily difficult questions—not just in this country, but in all countries individually and also at the international level.

A fundamental question is where to strike the balance between the undoubted benefits that flow from competition, including global competition, in financial services—in terms of financial resource allocation as well as for individual users of financial services—and the various social concerns just identified that argue for public intervention. Although most people would probably accept that some regulation can contribute to the competitive efficiency of financial services—by helping to retain the confidence of potential users of those services—there is, as in relation to many other forms of social intervention, plenty of room to debate the appropriate forms and degrees of financial regulation and the point at which it starts to interfere with the competitive efficiency or effectiveness of the financial system as a whole. The complaint that ‘we are over-regulated’ meets the counter-complaint that ‘we are underprotected’ often, unfortunately, accompanied by the complaint that services are too expensive or insufficiently available on an adequately competitive basis. The essentially political trade-offs in this area are especially difficult to determine because they are so much a matter of degree on either side, which it seems impossible to define with any precision.

The other very difficult issue (assuming that we do know just what it is that we are trying to achieve) is how we can best organise ourselves institutionally, in terms of the supervisory/regulatory structure.

Should that structure be based, for example, upon the type of financial institution, or on the type of activity, or on the type of user or on the particular social purpose being pursued? It is clear, from the diversity of structures across countries, that there is no single model, and any model would need to adapt as the market and as public policy interests change. It is tempting to think that all these problems could be resolved by sweeping everything together into a single financial services regulator—though I am bound to say that this approach seems to me seriously to underestimate the complexity of the issues. But whatever structure we have, there will need to be clear definition and understanding of the responsibilities of the different institutional elements in the structure (or different interests within a single institution) and intensive co-operation between them—both domestically and internationally. It is a difficult, on-going agenda which will take some time to work through.

As it is, the Bank of England is responsible for the authorisation and supervision of banks, under separate legislation—the Banking Act of 1987. This responsibility, to provide substantial, though not absolute, protection for depositors in individual banks, in fact fits comfortably alongside our traditional responsibility for the stability of the financial system as a whole. Notwithstanding the market developments that I have described, banks do still have distinctive characteristics giving them a key role in the financial system. Their balance sheets are still typically dominated by liquid liabilities on the one side and longer-term, predominantly non-marketable, assets on the other. This makes them especially vulnerable to liquidity pressures as a result of a sudden loss of confidence on the part of their depositors. Banks, at least in this country, still have a unique role in the payments, and therefore settlement, systems. Supervising each individual bank, therefore, equally helps us to monitor potential threats to institutions that are still, in this sense, at the heart of the financial system as a whole. And when preventative supervision fails—as it will inevitably from time to time—it puts us in a better position than we might otherwise be to assess whether a failure would create unmanageable difficulties for other financial institutions, and so to assess the case for lender of last resort assistance, or for seeking other solutions.

Now, of course, I accept that this is not the only possible arrangement. It does nevertheless have very considerable advantages of informational and operational synergy in relation to our concern with the stability of the financial system as a whole. And our continuous monitoring of individual bank behaviour can also provide insights and better understanding of the monetary influences on the macroeconomy, which are helpful in relation to our monetary stability purpose. These advantages would need to be weighed against the perceived advantages of alternative supervisory regulatory structures.

Whatever view one takes of these particular issues, two things seem very clear. First, that any central bank must monitor developments in the banking system very closely, and that will necessarily involve monitoring what is happening in individual banks. And, secondly, a central bank cannot, in the modern world, limit its view to developments in the banking system alone. Because systemic threats can originate in other parts of the financial system, and because of the speed with which they can be transmitted through the system, we must necessarily take a very close interest in the financial sector as a whole. This underpins our concern with financial stability but it is the foundation also of our third core purpose to which I now, finally, turn.

Seeking to ensure the effectiveness of the United Kingdom's financial services

This third core purpose we describe to ourselves as 'seeking to ensure the effectiveness of the United Kingdom's financial services', and we elaborate as

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

Now I want to be clear we do not mean by this that the Bank has, or thinks it ought to have, some sort of blueprint or dirigiste masterplan for the way in which financial services should develop in this country. That, properly, is for the market to determine through the interaction of competing institutions seeking to meet the evolving needs of financial services users. But there are situations in which there would be benefits to the community as a whole from collective initiatives, but where the market on its own finds it difficult to act because of the conflicting interests of the individual market participants. And it is in these situations where the Bank can play a useful role.

We have no formal locus in this area, we rely upon collective consent. But we do have a long and valid tradition of involvement, as a facilitator; and that tradition survives even in today's increasingly competitive environment, in which financial services have increasingly become governed by statute. And we are—both through the information, the expertise and the contacts that we acquire in pursuing our other core purposes and through our unique position somewhere between central government and the rest of the economy—well placed to play a constructive role. What is more this role helpfully complements and supports the rest of what we do. Let me give you some examples of what it involves.

The case for the Bank's involvement is perhaps most obvious and effective when it flows most directly from our other core activities. It was, for example, entirely natural and directly relevant that we should join with the banks and the Stock Exchange at the time of Big Bang to develop assured book-entry settlement arrangements for the gilt-edged market in which we ourselves are a major player—the Central Gilts Office. It was equally relevant that when the LondonClear project for money-market settlements, or the Taurus project for equity settlements, stalled, we should accept mandates from the market to develop appropriate systems in these cases too. Somewhat further removed from our own direct concerns, we took a close and benevolent interest in the market's successful endeavours to set up a financial futures exchange here in London, and we also played a match-making role in the subsequent merger of the London International Financial Futures Exchange and the London Traded Options Market. Now we are supporting the Stock Exchange in its current efforts to reform the equity market structure. In all of these examples (and there are many others) by contributing what we can to the effectiveness of markets in the first instance as an end in itself for the users of those markets, we are able also to reduce the risks in the financial system—through safer settlement and increased liquidity, for example. We also improve our understanding of the relevant activities which contributes particularly to our ability to identify and manage systemic risks that may arise in these areas.

Further along the spectrum, the Bank has, over a long period, encouraged the financial sector to identify areas in which its support for the wider economy could be improved. Through the founding of what is now 3i, for example, we contributed to the provision of venture capital to smaller companies. And we have more recently been very active in promoting a better understanding between the providers of finance of all kinds and the small business sector, not least because of the important part that small business can play in increasing employment. We also contribute to the development of the Private Finance Initiative. Through this kind of activity—and again drawing on our broader understanding of the financial system—we are able to play a constructive part in improving the structural context within which monetary policy has to operate.

I have tried to provide you with a rounded view of the Bank of England as an institution—covering all three of our core purposes rather than focusing on any one of them. There are, of course, all kinds of ways to skin a cat. But we believe that taken together our activities make a coherent whole; that the three core objectives complement and reinforce each other and that there is a synergy—of information, contacts and relationships, and expertise and experience—which makes it efficient to pursue those objectives together. I hope that I have persuaded you that the pieces do indeed fit together.