



BANK OF ENGLAND

Speech

Lord Mayor's Banquet

Speech given by

Edward George, Governor of the Bank of England

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Let me begin by congratulating you, Chancellor, on your overwhelming election victory, on your appointment, and, if I may, on your maiden speech at this traditional dinner for the Bankers and Merchants of the City of London.

But I congratulate you above all on your spectacular beginning in office! Much of the comment following your statement on 6 May - when you had been Chancellor for four whole days - focused on the institutional change that you announced, giving the Bank of England, through its new Monetary Policy Committee, operational responsibility for delivering price stability as defined by the Government's inflation target. And that institutional change certainly is important - not least to the Bank! But the real importance of the institutional change was that it demonstrated, as clearly as anything could have done, your commitment to stability and long-termism in the British economy.

My Lord Mayor, in defining his inflation target this evening the Chancellor has set the Bank a challenging objective. The technical implementation of monetary policy is not at all an exact science. It operates with long and unpredictable time lags so that we are necessarily continuously straining to peer into the future, relying substantially upon uncertain economic forecasts and carefully considered, but ultimately subjective, judgments about the balance of probabilities - and of risks - surrounding them. So I welcome the Chancellor's detailed reformulation of our marching orders, which acknowledges the volatility of the real world.

Not that I am already looking for excuses! On the contrary, I welcome unreservedly, too, the Chancellor's recent nominees to the Monetary Policy Committee who will participate in making the necessary judgments. Together with our inside team I could not ask for a professionally better qualified team to take on the important responsibility entrusted to it. The Chancellor has given us every chance to succeed - and we are all looking forward to the challenge.

I am well aware that some observers have been concerned that, in exercising its new responsibility, the Bank will adopt an unduly cautious approach, thereby imparting a restrictive bias to the economy. That will not be our intention. The new inflation target makes it amply clear that, in setting policy, we are to aim consistently at 2 1/2% as a mid-point. And that, of course, is what we will endeavour to do. Operationally it implies that, with a balanced distribution of risk, there should be an even chance of an outturn - at the end of our two-year forecast horizon - either above or below 2 1/2%. The measure of our success will be how close we in fact come to 2 1/2% on average over time.

Other observers go further, still arguing that there is a more fundamental conflict between monetary policy directed at price stability - however precisely that is defined - and the wider economic goals of growth, employment and rising living standards. The Chancellor has demonstrated, through his decisions, that he does not share that view. Nor, emphatically, do I.

That is why I have made a point on these occasions of drawing attention to both the rate of growth of output and the rate of inflation. Two years ago I reported to you that the rate of growth of output (measured by annual gdp growth in the year to the first quarter) had exceeded the rate of inflation (similarly measured by the gdp deflator) for two years in succession - for only the second time since the war. Last year we very narrowly missed a hat trick. But this year I can tell you that we have done it once again. That, my Lord Mayor, is three wickets in four balls. If our bowlers had performed like that at Edgbaston, at the start of Australia's second innings, we might have had the first Test wrapped up by the end of the third day! As it is - like the cricket - it is a very encouraging performance, and I am confidently looking forward to the rest of the over - and indeed the Test match series!

It means that, over the whole of the five years since we began to move out of recession, annual output growth has averaged 2.7%, and so too, on this measure, has the rate of inflation. Meanwhile, claimant unemployment has almost halved since 1992, to yesterday's figure of some 1.6 million people. That figure - even taken at face value - is still much higher than we would all wish to see, even though it is very much lower than in every other major country within Europe.

The point about these figures is that they do, surely now, demonstrate that there is no conflict - certainly no necessary conflict - between growth and price stability in the medium-term. What in fact monetary policy is trying to do, in order to maintain price stability, is to keep overall demand growth continuously in line with the growth of the supply-side capacity of the economy to meet that demand - no more, no less. If we are successful there is no reason why the economy should not continue to grow at around the underlying rate of capacity growth. Monetary policy can contribute to underlying capacity growth, indirectly, by maintaining stability in this wider sense. But capacity growth depends much more directly upon the whole range of structural, supply-side, factors, including labour market flexibility and welfare reform, as both the Prime Minister and the Chancellor have recently argued to their European colleagues.

My Lord Mayor, just two weeks after his initial announcement - the Chancellor announced a radical reform of financial services regulation. This included the eventual creation of a super-SIB, to which, inter alia, the Bank's present responsibility for banking supervision will be transferred. These reforms, too, have since been much debated in the City, and perhaps I might conclude with a few observations on them from the Bank's perspective.

There has, now, for some years, all around the world, been an on-going debate about the most effective structure for financial services regulation. It is driven partly by the rapid changes that are occurring in the financial services industry itself - as a result of innovation and globalisation which are having the effect of blurring the boundaries between traditionally distinct forms of financial intermediation. And it is driven partly, too, by a rising tide of public expectations in terms of both the prudential and the behavioural standards required of financial intermediaries.

What is clear from this broader, international, debate is that there is no single, or even predominant, model for the most effective structure of regulation that fits all cases for all time.

In the case of banking supervision, there is around the world a spectrum of arrangements, ranging from our own present arrangements - where supervision is wholly within the central bank, through various forms of banking commission with closer or more distant relationships with the central bank. Separation of responsibility for banking supervision from central bank responsibility for the overall stability of the financial system as a whole is not in itself at all unusual.

There are certainly powerful arguments for such separation.

Banking supervision - the setting of minimum prudential standards and endeavouring to ensure that they are respected - seeks to reduce the risk of failure in each individual bank, primarily in the interests of protecting depositors. This is not, I have to say, a natural habitat for central banks, which have traditionally been primarily concerned - long before the first Banking Act was introduced in 1979 - with seeking to prevent financial problems that may arise in one bank, or in one or other of the financial markets, from infecting other - otherwise healthy - institutions or markets. Combining these two, conceptually distinct, responsibilities, for banking supervision and for maintaining systemic financial stability, in one authority can, certainly in principle, result in a conflict of objectives and produce a 'cross-eyed controller'.

On the other hand, combining the two responsibilities within the central bank does have certain practical advantages. Central banks need a great deal of information about banks' balance sheets and behaviour, in relation to their monetary policy responsibilities - money is after all uniquely a liability of the banking system. And they clearly also need such information in relation to their responsibility for maintaining systemic financial stability - where banks remain of special importance because their balance sheets are still typically dominated by highly liquid deposits financing less liquid assets, which makes banks especially vulnerable to a rush for the exit if there is a loss of confidence.

Weighing these considerations I can see the case for separation - on grounds of the potential conflict of objectives. And I certainly will not mourn the passing of the criticism - whether or not it is justified - that is visited upon the banking supervisor whenever a significant bank does in fact fail - as will inevitably happen from time to time. The key question now is how best to minimise the practical disadvantages of separation, in terms of the Bank's responsibilities for monetary and systemic financial stability, by ensuring that we preserve very close links with the super-SIB, including particularly those within the SIB who will have responsibility for banking supervision. I have no doubt that we will indeed be able to establish the necessary close relationship - in our mutual interest - not least because the new super-SIB will be headed by our own Deputy Governor, who will be taking many of our own banking supervisors with him.

Let me say, finally, a word about the super-SIB itself - where the arguments are not dissimilar. Again there is no universally applicable model, but no-one who has had anything at all to do with our present 'confusion' of financial services regulators could fail to see the attraction of a single, all-purpose, regulatory body. It will undoubtedly clarify, to both the public and the regulated, where responsibility lies; and it should also be easier to resolve tensions between different regulatory approaches, where they emerge, under one roof. But here too there are potential practical disadvantages in a mega-regulator. It could become over- bureaucratic. It could mean a move towards a standardised, one- size-fits-all, approach to regulation. Or it could fail to maintain an appropriate balance between its responsibilities for protecting consumers and the need to allow competitive financial markets to breathe. These are, certainly, potential dangers. But they are not inevitable. In the final analysis it is not the regulatory structure that determines the outcome, but the way in which regulation is actually managed within that structure. Again in this context I am encouraged that Howard Davies is to become the first Chairman of the super-SIB. Howard is very conscious of the dangers I have described - and of the need to consult widely within the financial services industry as he moves ahead. He has a huge job in front of him, but I cannot think of anyone more likely to succeed. He has my strongest possible personal support as well as that of the Bank as a whole.

So let me conclude by thanking you for entertaining us all so splendidly here in the Mansion House this evening, by wishing you continuing success during the remainder of your mayoralty, and by inviting all your guests now to rise and join me in drinking to your continuing health and prosperity.

Ladies and Gentlemen, the toast is 'Good Health to our Lord Mayor, Roger Cork'.